Consulting Assistance on Economic Reform II

REPORTS

The objectives of the Consulting Assistance on Economic Reform (CAER II) project are to contribute to broad-based and sustainable economic growth and to improve the policy reform content of USAID assistance activities that aim to strengthen markets in recipient countries. Services are provided by the Harvard Institute for International Development (HIID) and its subcontractors. It is funded by the U.S. Agency for International Development, Bureau for Global Programs, Field Support and Research, Center for Economic Growth and Agricultural Development, Office of Emerging Markets through Contracts PCE-C-00-95-00015-00 and PCE-Q-00-95-00016-00.

Institutional Barriers to NonTraditional Exports
Case Studies of Ghana and Madagascar

J. Dirck Stryker and Ndaya Betchika

Report H
September 2000

For information contact:
CAER II Project Office
Harvard Institute for International Development
14 Story Street
Cambridge, MA 02138 USA
Tel: (617) 495-9776; Fax: (617) 495-0527

Email: caer@hiid.harvard.edu

INSTITUTIONAL BARRIERS TO NONTRADITIONAL EXPORTS CASE STUDIES OF GHANA AND MADAGASCAR

DISCUSSION PAPER

J. Dirck Stryker and Ndaya Beltchika[1]
Associates for International Resources and Development
February 1998

I. INTRODUCTION

This discussion paper presents the results of a study of the costs and benefits of eliminating institutional constraints on the expansion of nontraditional exports for Madagascar and Ghana.

The purpose of this study was two fold. The first objective was to develop a prototype methodology for identifying priorities regarding the promotion of nontraditional exports. The methodology is presented at length in a separate report published by A.I.R.D. [2] and is outlined in a separate discussion paper [3]. The second objective was to test the methodology in two African countries that have undertaken significant policy reforms aimed at achieving structural adjustment through outward-oriented incentives and greater emphasis on the private sector. More precisely, the study was to identify, measure the importance of, and estimate the costs and benefits of eliminating the constraints on the expansion of the nontraditional exports in which each country has a comparative advantage.

The methodology used in this report is an extension of the analysis of comparative costs and incentives that calculates indicators of domestic resource costs and nominal and effective rates of protection. It adjusts these measures of comparative costs and incentives for the costs of various institutional constraints. These costs are categorized according to whether they may be interpreted as an implicit tax or subsidy on tradable and nontradable goods and services. Alternatively, these can treated as elements of the real cost of doing business. For each case study, showcased in the subsequent sections, this document inventories a long list of potential constraints related to the legal, regulatory, and judicial (LRJ) environment. Whenever possible, these are identified as subsidies, taxes or part of the real cost of doing business. Then, for each country, the methodology is applied to a sample of nontraditional exporters. Each section is concluded by an analysis of the results and suggestions for policy recommendations.

---

[1] The authors edited the report: "Cost and Benefits of Eliminating Institutional Constraints on the Expansion of Nontraditional Exports, Final Report" by J. Dirck Stryker and Christopher Shaw, Cambridge, MA, AIRD, October 1994.

[2] J. Dirck, and al., *Costs and Benefits of Eliminating Institutional Constraints on the Expansion of Nontraditional Exports - A Prototype Methodology*, Cambridge, MA: Associates for International Resources and Development, March 1993.

[3] J. Dirck Stryker and Ndaya Beltchika, *Institutional Barriers to Nontraditional Exports in Africa*, Cambridge, MA CAER II discussion paper No--, HIID, February1998

II. GHANA CASE STUDY

A. Background

Ghana has been chosen as a case study country for several reasons. First, it has already undertaken major economic policy reforms that have been critical to the expansion of nontraditional exports. Among these reforms have been the devaluation and movement to a freely floating exchange rate, the elimination of taxes on nontraditional exports, the elimination of import controls, a sharp reduction in controls on foreign exchange, and a reduction and simplification of import tariffs. In addition, the government has provided additional export incentives through temporary admission, duty drawback, and bonded warehouse schemes for the duty and tax-free importation of inputs used in the production of exports, through exemption from sales and excise taxes on exports, and through an income tax rebate for exporters.

Second, Ghana's agro-ecological conditions give it a comparative advantage in the production of horticultural and other agricultural crops. It has the marine resources that enable it to export products from the sea. Its timber resources give it a comparative advantage in wood processing. It also has a cultural tradition suitable for the production and export of Afrocentric products. Lastly, despite a history of economic mismanagement, Ghana has a reasonably high level of education by African standards, and it has an entrepreneurial class with a long history of investment in new undertakings.

Third, Ghana is an interesting case study because it still has sufficient land and other natural resources, as well as a rich cultural heritage, that enable it to continue, for a time, to exploit its natural comparative advantage based on these resources before it has to develop new products for exports such as labor-intensive and standardized manufactured goods. In this sense, horticultural, marine, wood, and Afrocentric products can serve as a natural bridge to nontraditional manufactured exports, for which there are fewer cost advantages other than those involving labor. Thus, during this grace period, exporters can learn the importance for exports of market information, quality control, timeliness, and a host of other non-cost factors that are vital to competing in today's world market. Meanwhile, however, Ghana is also beginning to export standardized manufactured goods. It is thus important to discover whatever lessons can be learned from this experience.

Ghana has already demonstrated its potential for rapid growth of nontraditional exports. These increased from $24 million in 1986 to $63 million in 1991. As a share of total exports, nontraditional exports rose from 3.2% in 1986 to 7% in 1990.[4] Thereafter, a slump in European prices associated with recession led to a decrease in the value of exports notwithstanding a strong upward with respect to tonnage.

The most rapid and consistent growth has been in furniture and wood products and in handicrafts. Among horticultural exports, pineapple, yams/cocoyams, and fresh vegetables have done very well. Within the wood products industry, most of the expansion is of builders' wood and furniture and furniture

[4] Ghana Export Promotion Council.

parts. In the other processed and semi-processed category, exports of garments and fashion accessories have grown rapidly, as have those of kente products in the handicrafts category.

As for most African countries, Europe has been the most important trading partner for Ghana. Nontraditional exports to Europe, have steadily grown from 31 percent in 1986 to 53 percent in 1993 of total nontraditional exports earnings. Until 1993, the West African region, especially the CFA countries, was also a major market for Ghana. This trend was then reversed for most countries except Nigeria. Exports to CFA countries decreased from an average of 20 percent for the early 90's to a low 11 percent in 1993. Meanwhile, nontraditional exports to Nigeria remained at 8 percent in 1993. About one half of that trade is salt, a product in which Ghana has a strong comparative advantage, but much of the rest consists of products in which Ghana probably does not have a strong advantage. An important question is the extent to which this growth in trade has been due to overvaluation. Nontraditional exports to the United States hit a low 4 percent in 1990 but regained momentum and was at 10 percent in 1993.[5]

The number of exporters in Ghana has grown very rapidly. In 1992, 3188 exporters exported 164 products, compared with 2822 exporters in 1991, 1729 exporters in 1990, and 1381 exporters in 1989. In 1992, there were 1323 exporters of agricultural products, 1658 exporters of semi-processed and processed products, and 207 exporters of handicrafts. Fewer than 350 of all exporters had sales in excess of $10,000. The 70 or so exporters that shipped goods worth $100,000 or more accounted for 92% of the total value of nontraditional exports.[6] In most product categories, a few exporters dominate and the rest make relatively small shipments. This has been recognized by the Ghana Export Promotion Council, which narrowed the definition of exporter in 1993 so that only 1980 exporters were recorded, shipping 185 items.

Although the record of nontraditional export growth has been strong, major questions exist as to its sustainability and the potential that it has for becoming the mainspring of economic growth. For the moment, the nontraditional export sector is very small in comparison with Ghana's traditional exports of cocoa, minerals, timber, and energy. Growth has been rapid, but from a small base. There are major problems of telecommunications, high freight rates, limited contact with overseas markets, poor timing and quality control, and other areas that link foreign markets with domestic production. There are also numerous constraints involving such areas as administrative procedures, foreign exchange regulations, tax and import duty exemptions, access to financing, contract enforcement, labor legislation, land use rights, and a myriad of other aspects of export trade.

The following chapter describes briefly some of the major features of the institutional environment within which nontraditional exports are expanding. It also identifies the major institutional problems. This is followed by a discussion of the survey and a statistical analysis of its results. Following this there is a discussion of the methodology and a presentation of the results of the DRC/institutional cost analysis. Thereafter, the report distills all of the analysis for its policy implications.

---

[5] Ghana Export Promotion Council

[6] U.S. Agency for International Development, Bureau for Private Enterprise, *Financing Non-Traditional Exporters in Ghana: Assessment of Needs and Recommendations for USAID Assistance*, Final Report, prepared by First Washington Associates, Ltd. for USAID/Ghana, March 1992, p.14, and data from the Ghana Export Promotion Council.

B. Institutional Environment

Much has already been written about the institutional environment surrounding nontraditional exports in Ghana. This analysis has been instrumental, in fact, in improving that environment. Here are summarized the most salient features of this environment and the principal barriers to growth that remain are identified. In organizing this section, it is helpful to start with the conceptual framework of the legal, regulatory, and judicial (LRJ) environment, though it goes beyond it in the subsequent sections to deal with institutional mechanisms vital to export growth. Emphasis is put on trade legislation, investment incentives, land legislation, labor regulation, financial markets, foreign exchange, and direct taxation.

1. General framework

Ghana is unlike many African countries in that it has a highly developed legal infrastructure with a large number of judges and domestically trained lawyers.[7] However, like many of them, it superimposed a legal system inherited from colonial times, the English common law, on local law. Although the supremacy of English law was negated by post-independence governments, the duality of the legal system has been upheld by each new constitution.[8]

The Provisional National Defense Council (PNDC) which came to power at the end of 1981, chose to develop administrative agencies rather than the rule of law to support structural adjustment efforts. This contributed to its short-term success because it greatly simplified decision-making and made it easier to reduce the role of the public sector in favor of private enterprise. Consequently, the legal system has not been at the center of economic reform.[9]

The overall tendency has been to create promotional and regulatory agencies, such as the Ghana Investment Center, which seek to replace the statutes and independent courts in protecting property rights through institutional, rather than legal, means.[10] Although this speeds up the approval process, it also inevitably introduces a large degree of discretionary authority, which creates uncertainties for potential investors.

In the absence of an independent judiciary capable of resolving disputes, enforcing judgments, and independently interpret and administer the law, it is important to identify how these functions are fulfilled by other institutions and the constraints that this imposes on economic growth, in general, and on the expansion of nontraditional exports, in particular. To what extent, for example, are firms reluctant to invest because of the insecurity associated with inadequate safeguards over property rights? Do personal

---

[7] Julien E. Naginski, "Economic Conditionality and Legal Unconditionality: Structural Adjustment in Ghana (1983-1992)," MALD Thesis, Fletcher School of Law and Diplomacy, Tufts University, February 5, 1994, p. 7.

[8] Ibid, p. 4.

[9] Julien E. Naginski, "Economic Conditionality and Legal Unconditionality: Structural Adjustment in Ghana (1983-1992)," MALD Thesis, Fletcher School of Law and Diplomacy, Tufts University, February 5, 1994.

[10] Ibid, p. 27.

contacts and family or school ties take the place of more formal means of reducing risk and resolving disputes, and, if so, to what extent does this inhibit growth?

2. Trade Legislation

The principal legislation governing international trade in Ghana is the *Imports and Exports Act of 1980*. With the liberalization of the trade regime, however, this statute has been rendered obsolete.[11] The payment and drawback of customs and excise duties is governed by the *Customs and Excise Decree of 1972* and the *Customs Regulations of 1976*. The legislation related to nontraditional exports is the *Imports and Exports (Non-Traditional Exports) Regulations of 1987*.

Nontraditional exports are subject to a zero rate of export duty and are exempt from the payment of sales and excise taxes. Inputs used in the production of exports, unless exempted from the payment of taxes (see below), are subject to an import duty ranging from 0 to 25%, if imported, plus a sales tax ranging from 0 to 35%.[12] Current plans call for the introduction of a value added tax in early 1995. Exports will be exempt from payment of this tax.

a. Export Procedures

The problems associated with export procedures are very well documented.[13] All commercial exporters registered with the Registrar-General's department are required to register with the Ghana Export Promotion Council (GEPC) and the Ghana Shippers Council. The GEPC yearly registration fee is fixed and decreases from C25,000 for the first year to C20,000 thereafter. However, the fees paid to the Ghana Shippers Council vary on the basis on the age of the firm and the volume of trade. While many exporters do not consider receiving useful service from the GEPC in return, some appreciate the assistance given to them. With regard to the Ghana Shippers Council, virtually all exporters perceive no return.

In addition to these general organizations, most exporters also pay fees to industry specific professional associations. Firms reported to be more willing to paid those fees because the associations are in closer touch with the firms' problems and can more effectively intercede on their behalf.

The major exception to this is the C30,000 annual fee required by the Forest Products Inspection Bureau (FPIB), which also requires exporters to travel to Takoradi with their products and pay 1% of the

---

[11] This statute is currently being redrafted by the Ministry of Trade and Tourism to bring it in line with current policy.

[12] The higher rates apply to luxury goods. In most instances, duty rates were not greater than 20% and sales tax rates did not exceed 17.5% in 1992, the year to which the survey applies. The 1994 Budget Statement revised the upper duty and sales tax rate figures to 25% and 35%, respectively.

[13] The most detailed explanation and evaluation of these procedures is contained in Industrial and Management Services Limited (IMAS), *Final Report on Bureaucratic Constraints within the Non-Traditional Export Sector in Ghana*, prepared for USAID/Ghana, June 25, 1992. Also useful in summarizing and explaining the procedures is Ghana Export Promotion Council, *Beginner's Guide to Exporting*, Accra: n.d.

FOB value of exports in order for the Bureau to certify that the export contract is in order and that no rare species are being exported. Furthermore, the FPIB will not approve export contracts unless the prices reached are within price guidelines received from their agents in London. Port permits from FPIB are also needed before exports of wood products are permitted. All of this is perceived as being extremely onerous. It is difficult to justify these requirements, given the limited volume of wood contained in furniture and other wood products in relation to value added and the high cost of compliance in relation to any conceivable national benefit.

Besides these industry specific approvals, for each shipment, firms have to provide an Income Tax Certificate showing that all income taxes have been paid (C500). While useful in helping to enforce the assessment of income taxes, this has nothing to do with exports and must be considered as a barrier to trade. In addition to that, the Chamber of Commerce Certificate of Origin must also be obtained for each export shipment (C5,000). While this certificate may be required by the importing country, the question arises as to whether obtaining this certificate should not be optional for the exporter. It can be argued, however, that given the importance of preferential trading areas in Africa, this requirement is justified since a certificate of origin is required nearly everywhere. Thus, the potential cost to the exporter of not having the certificate when needed may be far higher than the cost of obtaining it in the few cases where it might not be needed. For this reason, the requirement to obtain a certificate of origin is not treated here as an unnecessary institutional cost. The Ghana Standards Board approval (C5,000), which is optional will be treated in a similar fashion.

As goods are being prepared for export, the exporter must obtain from his or her bank the Exchange Control Form A2, which must be completed and returned to the bank with a commercial invoice and all the export approvals and permits described above. Banks typically charge 1% to 1.25% of the FOB value of the shipment for processing these forms and handling the foreign exchange transactions, of which 0.5% goes to the Bank of Ghana. More importantly, the commercial banks use this form to bind their customers to them when the former convert their foreign exchange earnings into local currency, thus allowing the banks to exercise some degree of monopoly power over the exchange rate at which this transaction takes place. Most of the information obtained on the Form A2 is also contained on the Customs Entry Form, so there appears to be considerable redundancy and unnecessary expense involved. Since the Customs Entry Form is internationally standardized, if the Bank of Ghana still wants supplementary information, it could continue to use the Form A2, but this form should not have to be approved by the commercial banks and the exporters should not be charged for processing the form. As it stands, the fees charged and the requirement that the Form A2 be approved by a commercial bank amount to an implicit tax on exports.

Once goods are taken to the port or the airport, the exporter is required to present a Customs Export Declaration Form (C5,000) and to have it processed by the Customs, Excise and Prevention Service (CEPS) and the Ministry of Trade office. In addition to the direct cost, it is customary to tip in order to expedite the process. If a forwarder carries out these operations for the exporter, he normally charges for these tips under the category "sundries". The cost of this tips vary according to the size of the shipment. They are reported to vary from C500 for a small package to up C50,000 for a 20’ container. While not strictly legitimate, these tips are widely recognized and accepted.

Agricultural goods must, at this point, obtain a Plant Protection and Quarantine Certificate (C500) from the Ministry of Agriculture, and fish and fish preparations must obtain a similar certificate from the Fisheries Department of the Ministry of Agriculture (C500). These shipments are also required to obtain a Port Health Certificate. These are standard procedures anywhere in the world.

b. Imported Input Procedures

Ghanaians exporters must compete actively on international markets with exporters who for the most part benefit from internationally accepted mechanisms. In addition to streamlined export and import procedures, Ghanaians exporters must have access to duty and tax-free inputs for production destined to exports.

The impression gained from informal conversations with exporters is that the procedures for clearing imported inputs are more cumbersome and the delays are longer than for exports. The procedures involved in importing intermediate inputs are similar to those required for exports. The importer must have the proper documentation, including bill of lading, packing list, invoice from the supplier, clearance from SGS certifying that the invoice amount is correct, Income Tax Certificate, Customs Bill of Entry Form, Ghana Shippers Council Certificate, and health and fumigation certificates if the imports are food items. He or she must also prepare an Import Declaration Form, which is submitted to a bank in order to transfer Cedis into foreign currency. Forwarding agents estimate that the time for clearance averages two weeks, but it can take up to several months. However, they also reported that it could be accomplished in 3 to 5 days.

While some mechanisms exist to provide intermediate inputs duty free, these procedures do not work effectively. Duty-free admission of imported inputs is governed by the *Customs and Excise Decree of 1972 (NCRD 114)*, which is supplemented by the *Customs Regulations of 1976*. These provide for duty drawback, duty exemption, duty suspension, and bonded warehouses.[14]

Duty drawback. The rebate of import duties and of sales and excise taxes paid on imported inputs applied to goods exported either in the same condition or after some process of manufacture. It operates on a case by case basis requiring firms to submit applications based on detailed, auditable evidence that duty and taxes were actually paid, inputs were actually used, and exports actually took place. In addition to numerous administrative steps, applications take several month to process. Consequently, the value of the drawback is eroded by inflation, financial charges and administrative costs. Furthermore, it has been reported that many applications get rejected on technicalities.

The drawback system used in Ghana only takes applications from exporters who have directly imported the dutiable inputs. This creates a bias against domestic suppliers of inputs used in exported goods, unless it can be clearly shown that the locally furnished input could only have been used in the production of exports.

[14] Much of the material in this section is taken from Norberto A. Quezada, "Ghana: Duty Relief Instruments for Non-Traditional Export Promotion," Sigma One Corporation, June 10, 1992.

Many Asian countries have used a set of input-output coefficients to determine the level of duty relief based on the level and type of imports used in exported goods. This method has the advantage to alleviate the need for detailed verification of actual taxes paid, thus it is a simplification of procedures. However, it does not solve the problem of capital tied up from the time taxes are paid until the refund is paid.

Duty exemption. Importers can obtain duty exemption through the Ghana Investments Center (GIC) or by certification from another government agency. There is no general exemption for intermediate products that are used in the production of exports, but the Revenue Secretariat can grant exemption on a case by case basis. Similarly, sales and excise taxes can be deferred until after production, at which time the final products are exempted if exported. It is clear that this system is fraught with discretionary decisions that are subject to abuse.

Duty suspension. Suspension or conditional exemption from duty can be granted by the Commissioner of Customs if the imports are intended for re-export in the same condition within three months and a bond is posted for the dutiable amount. Suspension is rarely granted and, in any event, is not applicable to intermediate products used in the production of exports.

Bonded warehouses. The customs code allows for the establishment of warehouses to hold imported goods temporarily without payment of duty. The latter is postponed until the importer is ready to take possession of the goods. If the goods are re-exported in the same condition, no duty is paid. This is also true if the goods are used in the manufacture of products that are exported. This system appears to be increasingly used in Ghana. However, because of the need for monitoring by the customs service, it is limited to medium and large firms.

3. Investment Incentives

Foreign and domestic investment outside the petroleum and mining sectors is governed by the *Investment Code, 1985 (PNDC Law 116)*; the *Investment Code (Areas of Special Priority) Instrument, 1991*; the *Investment Code (Amendment) Law, 1992*; the *Investment Code (Immigrant Quota) Regulations, 1992*; and the *Technology Transfer Regulations, 1992*. This legislation has been a very important part of the institutional environment influencing business decisions. It establishes the Ghana Investments Center (GIC) as the one stop agency of the government responsible for the encouragement, promotion, and coordination of all investments in the Ghanaian economy with the exception of the mining, minerals, and petroleum sectors. The duties of the GIC include:

1. collection, analysis, and dissemination of information about investment opportunities and sources of investment capita;
2. identification of specific projects and invitation to potential investors for implementation;
3. organization of promotional activities;
4. approval of the establishment of enterprises under the Code;
5. approvals qualifying investors for benefits under the Code;
6. securing of all licenses, approvals, permits, etc. required for any approval granted by the Centre to have full effect;

7. liaison between investors and ministries, public agencies, institutional lenders, etc.;
8. monitoring and enforcement of compliance with terms and conditions of approval granted under the Code;
9. approval of technology transfer agreements relating to investments under the Code; and
10. recommendation of changes in legislation and simplification of procedures.

The Code also defines certain priority areas for investment, as well as the incentives and benefits under each category. The priority areas were originally designated as agriculture, manufacturing, construction, and tourism. These priority areas were detailed much more specifically and expanded to include the service sector in 1991. Benefits include exemption of customs duties for the importation of plant and equipment, investment and depreciation allowances for income tax purposes, and income tax rebates and exemptions. The legislation also allows the retention of at least 25% of foreign exchange earnings in an external account and free transfer of dividends, profits, loan service payments, technology transfer fees, and capital proceeds upon liquidation or sale. There is also a guarantee against expropriation.

As subsequently amended in 1992, the Code calls for a minimum foreign investment of $10,000 for a joint venture and $200,000 for a wholly foreign-owned enterprise (also required to be a net earner of foreign exchange). This minimum capital requirement is suspended for export trading enterprises. A separate section originally listed twenty types of enterprises wholly reserved for Ghanaians, but this was amended in 1992 to limit the list to four types. Legislation in 1992 also specifies immigration quotas of two to four persons, depending on the amount of investment, for firms under the Code.

In practice, the GIC has become more of a regulatory agency than one responsible for promotion. The complexity of the Code and related legislation has resulted in a highly discretionary approval process, in which projects are evaluated with respect not only to their priority for the government but also their viability. Despite the supposed one stop role of the GIC, approvals in fact have to be obtained from numerous individual ministries, and this can take months.

As a result of these and other problems, the Code is being revised to decrease GIC's regulatory and approval power and to increase its promotional role. The revised code should reduce discretionary authority and the role of individual ministries in the approval process. It should also include lower capital requirements which would be set at $10,000 for a joint venture and $50,000 for a wholly foreign-owned firm because of the inability of many Ghanaians to raise much capital.

The revised code has yet to be approved by Parliament. It remains to be seen how this new orientation will work out both legally and in practice. One important question relates to the applicability of Code benefits to wholly Ghanaian-owned firms. In principle they are available, but in practice they have not been, at least until recently. This raises the issue of whether it would not be better to eliminate the special Code status altogether and to incorporate most of its benefits into legislation applicable to all firms.

4. Land Legislation

In 1986, the Government of Ghana enacted the *Land Title Registration Law*, which deals with the concerns of private and/or legal persons who seek to acquire land in Ghana aimed at promoting business activities in the traditional and nontraditional export sector. This law replaced the *Land Registry Act 122*, which suffered from a diverse set of problems, ranging from uncertainty of title for acquisition of land and lack of precision in registration procedures to the absence of rules governing arbitration in cases involving land disputes.

The legislation introduced the system of mandatory land title registration to guarantee transparency, speed, and timely handling of matters concerning land acquisition in Ghana. This new system of land title registration is aimed at facilitating proof, rendering dealings in land safe and simple, and preventing fraud on purchasers and mortgagors. All private individuals or enterprises who engage in the promotion of traditional or nontraditional exports have welcomed the new legislation since it provides a warranty of title for all persons registered as owners and acts as a bar to adverse claims.

While the new legislation is an improvement over the old one, conditions of title registration remain very onerous because one has to know the history of the land very well and have very detailed surveys. Ghana has still a long way to go, considering that the land registration system in the UK , which Ghana has inherited, is 50 years old and not even all land is under title to date there. Instead, most land is registered by deed, which is almost equivalent to title registration but is considerably simpler.

Overall, the goal of the new system is to provide for transparency and timeliness in procedures. If the documents are well drawn, procedures can be completed in about 10 days. But often documents are faulty and since the Commission does not have the right to correct them, they must be returned to the submitter. Thus the process takes longer. It can, however, be expedited for a fee of C10,000. Search costs in any case are C2500/acre.

5. Labor Regulation

The *Industrial Relations Act of 1965* and the *Labor Decree of 1967* are the two government laws concerning labor in Ghana and they apply to all establishments irrespective of their nature. Investors (foreign and domestic) must go through the Ministry of Labor for recruitment of labor (skilled and unskilled). This has been expressed as one of the major areas of concern for potential foreign investors. In practice, these regulations are perceived as quite cumbersome, costly, and time consuming. It makes the hiring process lengthy and uncertain. The Ministry of Mobilization and Productivity is also supposed to monitor the firms' compliance with the labor laws, but in practice well connected investors circumvent this barrier effectively.[15]

Minimum wage is regulated by the Tripartite Committee on Wages and Salaries, which consists of representatives of the government, employers, and trade unions. At the company level, employers negotiate wages with employees with the exception of manufacturing industry, where the Industrial and Commercial Workers' Union of TUC (Ghana) assumes the responsibility of negotiating wages with employers. According to law, enterprises can be closed and workers retrenched; however, the

---

[15] Samuel Paul, *Assessment of the Private Sector, A Case Study and Its Methodological Implications*, World Bank Discussion Papers 93, 1990, p. 29.

retrenchment process must be initiated with an advance notice of about two months and consultations with unions representing the company's unions are required. In reality, however, retrenchments are conditional on the approval of powerful political groups such as the Committee.

Overall, the operation of the labor market seems to be driven by a multiplicity of formal and informal regulatory barriers. For example, for the laying off of workers, the political and financial aspects are so significant that the release of inefficient workers becomes very difficult. Although laying off of workers is an unpopular decision for all parties involved, it is a crucial factor that must be considered from the firms' point of view. Lack of flexibility in this respect is likely to discourage employment at the margin, and weigh heavily in investors' decisions.

6. Financial Markets

In Ghana, nontraditional exporters can finance their exports through various ways. The financial institutions include public and private commercial banks, three merchant banks, and one government backed export finance institution -- the Export Finance Company (EFC) -- that offer financial services to exporters. Since the initiation of the Financial Sector Adjustment program in 1988, the financial sector in Ghana has experienced major changes. Particularly, commercial banks have seen their organizational structure, management, and operating procedures altered. Simultaneously, they have revised their lending policies and practices to the export sector. Each of these institutions can finance nontraditional exporters.

Despite these avenues, nontraditional exporters have expressed their dissatisfaction with the availability of capital. For instance, credits by commercial banks to nontraditional export trade have decreased in relative terms substantially, reaching only 4.4% of total bank credit in 1990, after attaining 5.1% in 1987.[16] In Ghana, as in many other developing countries, financial institutions are conservative, risk averse, and prefer to lend mainly shorter term credits at high rates of interest. They offer small amounts of credit to exporters and require more collateral than in industrial countries. Many banks require 100 percent collateral or, more, specifically, liquid collateral (cash, certificates of deposit, or marketable securities) or real estate. Inventories are seldom used as collateral because of the problem of guaranteeing their security. Even real estate offers poor collateral because of difficulties of foreclosure through the legal system. Furthermore, Ghanaians banks are less experienced and well-connected internationally than their counterparts in industrialized countries and, as a result, are less willing to make export loans. Finally, they are discouraged from making loans by the alternative of investing in Government and Bank of Ghana bills and bonds, which until recently paid rates of interest up to 35%.

Another constraint is the perceived high cost of export financing. Until recently, interest rates were kept at higher levels in Ghana than on the international market because of high rates of domestic inflation. Although many exporters complained that they were therefore less competitive compared with foreign suppliers, this ignored the very substantial gains that they made as a result of the depreciation of the cedi. Nonetheless, only a small percentage of exporters use the banking system to finance their

[16] USAID, *Financing Nontraditional Exporters...*, p.22. This figure excludes lending to cocoa, timber marketing and minerals, but includes credit for diamonds and gold.

exports. Also, many nontraditional exporters do not qualify for loans from the banking sector because they lack banking experience and have poor collateral.

Credit is important to nontraditional exporters at all stages, beginning with the need to finance pre-shipment needs for working capital, to purchase inputs and to manufacture and pack goods for export. Credit is also important at the post-shipment stage to bridge the gap between the shipment of goods and the receipt of payment from overseas purchasers. Nontraditional exporters have access to pre-shipment and post-shipment financing from commercial banks upon provision of confirmed, irrevocable letters of credit (LC) or export documentary collections as verifiable evidence for their export transactions.[17] All commercial banks provide pre- and post-shipment working capital loans under lines of credit established on an annual basis. Most recently, banks have developed bankers' acceptances, which are held in portfolio and can be rediscounted at the newly formed discount houses.[18]

Nontraditional exporters can also receive financial services from merchant banks. These banks have not had to be restructured and, due to their conservative lending policies and their young age, they are less troubled than commercial banks. Merchant banks cover all the services provided by commercial banks in addition to managing money and being active in the capital market. For example, they advise and confirm letters of credit, provide pre and post-shipment loans to exporters, participate in foreign exchange transactions, and provide foreign exchange services. Merchant banks see themselves in a better position to provide such services than commercial banks. Furthermore, exporters have easier access to financing at merchant banks due to their more flexible collateral regulations. However, small exporters face similar problems with merchant banks as with commercial banks.

In order to remedy the problem of access by small exporters to trade finance, the Export Finance Company (EFC) was created to provide assistance to smaller nontraditional exporters in acquiring short-term loans from commercial or merchant banks. Instead, however, the EFC provided direct loans to exporters of 90-180 days for specific transactions evidenced by confirmed export orders or letters of credit. Furthermore, the EFC financed up to 100 percent of the costs of producing the export order, including purchase of raw materials, processing, transport, etc. Overall, the EFC supported a larger number of exporters compared to the merchant banks and commercial banks. Unfortunately, the EFC has also had considerable difficulty collecting its loans, and its financial viability remains in doubt.

As mentioned above, there are some problems involving access to short-term capital, especially for smaller exporters. However, the most important financial constraint is the availability of capital for fixed investment. This is of little interest to the commercial banks, and even the merchant and investment banks, given the problems of the past and the availability of alternative financial instruments that they can hold and on which they receive a reasonable rate of return. There are several special programs, offered by the donors, to finance the purchase of plant and equipment in order to increase or upgrade production capacity. Yet, size and other program eligibility requirements limit the usefulness of these programs to

[17] The advantage of LCs is that the commercial banks know before shipment the terms and conditions under which the exporter will be paid. In case of export documentary collections, on the other hand, the banks only know after shipment the terms under which the seller anticipates being paid.

[18] USAID, *Financing Nontraditional Exporters…*, p. 31.

meet widespread needs of exporters. Furthermore, some exporters have had bad experiences with these programs, largely because of the depreciating cedi and the terms upon which the loans had to be repaid.

Several other recent initiatives are worthy of mention. The Export Finance Office being set up under the Private Enterprise and Export Development Project, financed by the World Bank, will provide short-term guarantees, up to 65% of the face value of the loan, to banks for pre-shipment finance. There will also be a 100% rediscounting facility designed to facilitate the commercial banks' cash flow. The Exim guaranty Company has been established to provide credit guarantee cover to medium and small enterprises and to reduce the risks associated with trade finance, including post-shipment loans that cannot receive guarantees from the Export Finance Office. Credit guarantees can also be used for term loans up to a maximum of 15 years. Finally, the Ghana Leasing Company, which has been in business since 1992, assists companies interested in making fixed investments, though its operations are for the moment restricted to the larger, more successful firms.

In sum, financing remains an important factor for the promotion of nontraditional exports in Ghana, both for working capital and for plant and equipment. A few exporters operating in the formal sector possess the requisite financial and accounting knowledge to obtain financing for their activities to export internationally on a competitive basis. Most exporters, however, face various financial constraints, including high cost of capital, difficult collateral requirements, cumbersome procedures, and poor access to working capital and term finance. Those exporters operating in the informal sector, particularly, as well as those with rudimentary accounting and financial knowledge, as well as performance or loan repayment problems, have had difficulty obtaining funds from financial institutions.

7. Foreign Exchange

Following the introduction of the Economic Reform Program in 1983, foreign exchange management was progressively liberalized. As a result, access to and use of foreign exchange has few restrictions and the exchange rate of the cedi is now largely market determined. Interest and dividends are allowed to be remitted abroad and capital can be repatriated with no restriction, though Bank of Ghana approval is required. Ghanaian residents are allowed to maintain various types of foreign exchange accounts.

Foreign exchange retention and external accounts are the two important accounts relevant to enterprises. Prior to 1993, nontraditional exporters could deposit 35% of their export earnings directly in these accounts; the other 65% had to be converted to cedis at an exchange rate determined by the commercial bank, or in the case of some large transactions by the Bank of Ghana. The 65% requirement was eliminated in early 1993, though exporters still find it necessary to convert foreign exchange into cedis to pay their local bills. Furthermore, commercial banks that approve the Form A2 often require that the foreign exchange earned under this approval be converted through them into local currency, thus maintaining some monopoly power over the exchange rate at which this conversion takes place. This is a problem especially for smaller firms that do not have the bargaining power of the larger firms in their negotiations with the banks. Nevertheless, the inter-bank market for foreign exchange has become increasingly competitive, so that that costs of this requirement have been considerably reduced.

Continuing liberalization of the financial sector requires frequent changes in procedures. As a result, there is widespread lack of information about the procedures governing foreign exchange transactions. The latest regulations are not available to all parties; sometimes even the staff of the banks is not informed about changes in the regulations. Nevertheless, Ghana has made enormous progress in its foreign exchange management and it would benefit by making potential investors aware of the country's liberal foreign exchange regime.

8. Direct Taxation

The tax regime has a significant impact on the level and composition of investment. In Ghana, enterprises are taxed according to the *Income Tax Decree of 1975* through a combination of taxes on profits, dividends, and capital gains. However, the *1985 Investment Code* provides generous incentives in the form of capital allowances, tax rebates, tax holidays, and duty exemptions on equipment for a wide range of priority activities.[19] The Government's objective in this area is to balance the demands for a low marginal effective tax rate to encourage investment versus the need to generate revenue.

Chargeable income tax rates for enterprises in Ghana are high compared to rates in many other developing countries, even though they were reduced in 1991. The enterprise income tax is 45 percent for companies in construction and real state development; the rate is 50 percent for all other companies, including farming companies and companies in banking, insurance, commerce, and printing.[20] In many other countries, an income tax rate of 30-35 percent is the norm. Industries that are granted exemption under the *Investment Code* have to pay a minimum tax of 5 percent of turnover after the first five years irrespective of the actual profit of the business.[21]

There is a 30 percent final tax on dividends paid out by the company from its after tax income. The capital gains tax rates on the sale of assets, including business stocks and shares, are also high and vary with the length of the holding period (from 55 percent for assets held for less than 5 years to 15 percent for assets held over 20 years).

Another disincentive is the use of historic cost as a basis for calculation depreciation, as stipulated by the tax code. If asset prices rise rapidly due to exchange rate adjustments, profits (and taxes) are inflated, and eventually firms will have difficulty replacing their assets. The lack of general carryover of operation losses deters investment particularly in ventures that expect returns in the longer term of face more than average risks.

High capital gains taxes also deter firms from engaging in mergers and acquisitions that are urgently needed for the rationalization of the manufacturing sector and the divestiture of public enterprises.

---

[19] Ministry of Industry, Science and Technology, *Kind and Level of Protection Required by Ghanaian Industries*, Draft Final Report, Submitted by Plan Consult in association with Louis Berger International, Inc., p.45.

[20] Ibid, p. 48.

[21] Ibid, p. 46.

The high tax on capital gains and dividends also deters equity financing; at present, rewards of successful ventures are largely taxed away, and investors are likely to choose a safer outlet for their funds, such as tax exempt government bonds.

All domestic earnings of foreign companies and individuals are subject to the same taxes as for Ghanaians except for the Selective Alien Employment Tax for each expatriate employed (500,000 cedis) unless exempted by the GIC. There is a minimum tax of 35 percent on total income of foreign businesses. Ghana has no active double taxation agreements with other investor countries currently.

C. Survey of Nontraditional Exporters

In order to better identify the institutional constraints facing nontraditional exporters and to get their perspective about these constraints, the relatively rich documentation on Ghana's nontraditional exports was consulted, and informal interviews were conducted with officials in the government, banking sector, professional associations, and private firms engaged in nontraditional exports. Their patience, good will, and keen insights into the problems of nontraditional export growth allowed the team to draft a questionnaire, which was subsequently administered to a total of 44 firms by a team from Databank Ghana Limited during March-June 1993. This questionnaire was in two parts. The first was essentially qualitative in nature and was designed to assist in identifying the most important constraints on the expansion of nontraditional exports; the second part, which was completed by about half of the firms, was quantitative and was used to estimate comparative cost and incentive indicators and to adjust them for the costs of institutional constraints.

The survey included 44 firms which included the following industries: horticulture (9); other agriculture (3); marine products (5); processed foods (3); furniture and wood products (5); garments, textiles, accessories, and handicrafts (7); other manufactured goods (8); scrap metal (1); and salt (1). The nature of the survey, which required considerable cooperation on the part of senior management prompted the team to hand pick the enterprises. The sample of firms was chosen on the basis of personal contacts and known propensity for cooperation, keeping in mind the need to maintain diversity of product, size, experience, and other characteristics. The results of the survey cannot, therefore, be regarded as definitive, but rather as exploratory and suggestive.

The quality of the data, especially, from the second part of the survey, varied substantially. In some cases, it was necessary to complement this information with that from other sources. In the end, it was possible to estimate comparative cost and incentive indicators for 17 firms and to conduct statistical analyses for most of the 44 firms in the sample.

In this section, we first describe a number of characteristics of the sample firms included in the survey. These characteristics include age, years of export experience, value of total sales, value of exports, employment, ownership, major markets, capacity utilization, sources of finance, type of collateral used, and similar variables. We also consider the importance attached by the firm to different constraints, exemptions from or credits for taxes paid, delays in clearing exports or imported inputs, and other variables directly related to export activities. In addition to this quantitative description of the sample of firms, there is also a more qualitative discussion, including an exploration of the problems experienced in some of the major industries.

The second part of this section presents the results of a number of regression analyses that were run in order to estimate the independent effects of different variables. This permits the testing of several of the hypotheses that were suggested in the preceding section.

1. Characteristics of the Sample

a. Quantitative Description

The firms range in age from 1 to 43 years, with the mean year of registration being 1979 and the standard deviation 11 years. About half the sample first registered before 1985. Most have had little export experience -- the mean year in which the firm first exported is 1989 and the standard deviation is only 4.6. This suggests how important the reforms were in creating an environment for nontraditional exports.

The range of firm size in the sample varies considerably. The mean value of total sales is 659 million cedis, with a standard deviation of 1539 million cedis and a range from 1.3 million to 9 billion cedis. The mean number of employees is 151, with a standard deviation of 401, and a range of 2 to 2300.

Forty percent of the firms in the sample have been approved under the Investment Code. Thirty-three of the firms are wholly Ghanaian owned, and 9 are joint ventures; none is wholly foreign owned.[22]

Twenty of the firms list Europe as their principal market, while 11 firms list West Africa and eight firms list the United States. Eighteen of the firms have a foreign firm act as their distributor, two firms use a foreign firm for technical assistance, and five firms receive market information from a foreign firm. Equally interesting, 18 firms do not indicate any kind of close relationship with a foreign firm, and only six firms indicate that their foreign partner has any kind of financial stake (26 firms, however, did not reply to this question).

Nineteen out of 39 firms cite lack of capital for fixed investment as a major constraint. This is especially interesting since the mean level of capacity utilization is only 55%, with a standard deviation of 26% and a range from 8% to 100%. This suggests that much of the equipment being used is old and in disrepair.

The second most frequently cited constraint is either lack of overseas markets or lack of knowledge of overseas markets (12 firms), followed by inadequate labor skills (10 firms), and inadequate product quality (3 firms). Only two firms each list lack of working capital or unreliability of input supply as constraints, and only one firm each lists unreliable overseas importers or long delays in payment.

With respect to the use of export incentives, 12 firms have received an income tax credit for their exports, 4 firms have applied for but had not yet received a credit, 8 firms are exempt from income tax

[22]All the firms did not respond to each question so that the sum of the firms in each category is generally less than the total of 44 firms in the sample. In this instance, for example, only 42 firms responded.

due to their investment code status, and 19 firms have not applied for a credit, in most cases because they did not know about it. On the other hand, 29 firms have received exemption from sales and excise taxes on their exports, 4 firms have not applied for exemption, and 11 firms did not respond to this question.

The mean delay in clearing export shipments is reported as 3.7 days, with a standard deviation of 3.3 and a range of 1 to 14 days. Only one firm reports that this delay has resulted in its not being able to meet an order, while three firms report other problems associated with delays. The mean delay in clearing imported inputs is much longer -- 8.9 days, with a standard deviation of 6.0 and a range of 2 to 20 days. As a result of these delays, two firms report that they have to hold larger inventories of inputs and one firm says that it is obliged to purchase more inputs locally than it would like. Despite the fact that these delays do not appear to be a major problem at the present time, they could become so as firms begin to compete more actively on the world market, where timeliness is important.

With respect to trade finance, 19 firms report that they have used either an overdraft or a loan backed by a letter of credit. Twelve firms say that they have used their own capital to finance their exports, seven firms have obtained financing from overseas importers, two firms have received financing from their parent company, and three firms report other sources of financing. Nine firms report using real property as loan collateral, and three firms say that inventories have served as collateral. The average loan amount is 56 million cedis, with a standard deviation of 97 million and a maximum loan of 300 million cedis. The average loan duration is quite long -- 187 days, with a standard deviation of 247 days and a maximum duration of 999 days. Interest rates average 26%, with a standard deviation of 11% and a maximum rate of 46%.

b. Qualitative Analysis

Not all of the information obtained in the questionnaire can be quantified as easily as that described in the preceding section. It is useful, therefore, to provide a brief description of some of the problems cited, both generally and for specific industries for which the country has a comparative advantage. These industries include horticulture; marine products; garments, textiles, accessories, and handicrafts; and furniture and wood products.

i. General

Financial services

Firms complain of lack of investment capital, yet at the same time they are operating at a 50-60% or lower rate of capacity utilization. One explanation is that much of the existing capital is old, in bad repair, and outmoded. Broken or outmoded equipment and the inability to easily import parts slows production and raises costs. Another explanation for low rates of capacity utilization is the need to produce in large volumes on demand. If a seller cannot fill an order, either on a regular basis or on special command, he often loses the customer. The capacity to fill large orders is especially important when exporting to Europe or the United States, where there are important economies of scale in marketing.

Lack of capital for fixed investment is likely to become an increasingly important constraint on the expansion of nontraditional exports. For example, one exporter noted that pineapple operations were too capital-intensive, which is why he switched to producing yams and mangoes. As pineapple production increases, Ghanaian pineapple firms will become less competitive unless they can get access to the capital they need for fixed investment. Firms which have neither sufficient capital of their own nor confirmed, irrevocable letters of credit must put up other collateral in order to obtain loans. In most cases, this takes the form of real estate holdings. A few others have used inventories as collateral, but banks are generally unwilling to accept this in Ghana because it is difficult to guarantee the quality of these stocks in the event of foreclosure. Even real estate is less than ideal as collateral because of the difficulties encountered with and the long time required for foreclosure in the court system.

In addition to loans from financial institutions, most firms resort to self-financing for a large part of their financial needs. This has the advantage that they do not have to wait for bank approval, there is no uncertainty regarding their gaining that approval, and the implicit cost of using their own capital is less evident to them than the cost of borrowing.

Market opportunities

Some firms, especially in the horticulture and marine industries, report not having problems finding market opportunities. According to these firms, they can sell as much as they can produce. However, other products are more difficult to market, especially for those firms geared exclusively to markets in Europe or the United States. These products require higher quality with more skilled workmanship, but most firms exporting to these markets do not seem too pessimistic about lack of skilled labor, the main concern being finding a larger market. Although most business contacts are through networking, and very few are through trade fairs, there seems a desire to find more contacts through impersonal means.

Telecommunications

Telecommunications is increasingly becoming a vital element of international trade. Firms who cannot afford fax machines, cellular phones, and other modern means of communication encounter significant barriers to international markets. All firms, however, experience major problems with telecommunications within Ghana.

Export and import procedures

Most firms in the survey do not feel that procedures regarding exports or the importation of inputs are a major barrier to nontraditional exports. Export procedures have been substantially simplified over the past few years, and clearance, which is often handled by a forwarding agent for the smaller firms, should normally take no more than three days. Most of these procedures are internationally accepted, though there are a few local requirements that should be eliminated, and others that need to be clarified, especially in view of the high degree of competitiveness that characterizes world markets.

For instance, payments must be made by exporters to the Ghana Shippers Council even though virtually all firms say that this organization provides no services. Second, procedures to obtain clearance for furniture and wood product exports are particularly cumbersome and costly. Guidelines regarding export procedures are often not clear. New entrants into these exports, especially, are often bewildered by the complexity of the procedures. One firm went back and forth several times to the Board of

Museums and Monuments before it was eventually told that it did not need approval from the Board. Time spent on clearing exports varies widely from firm to firm, indicating a lack of formal guidelines or knowledge of the guidelines for each industry. Lastly, import taxes on inputs are either high or there are none, which distorts profitability not only between but also within industries.

Customs officials generally receive side payments to facilitate the processing of both exports and imports. These amount to about 0.5 percent of the FOB value of exports and are probably very difficult to eliminate for the foreseeable future. Extortion of unusually high payments can occur when rapid processing is of high priority, but this does not appear to be a major problem because of the widespread understanding that exists of what constitutes a reasonable level of payment to officials.

Contract enforcement

Contract enforcement can be a problem for firms without well established linkages with foreign importers. Even domestic contracts are difficult to enforce because the judicial system in Ghana is very slow and costly. As a result, business transactions tend to be confined to those with whom a firm has personal experience or social ties.

Transportation

The cost and availability of freight is a significant problem. The cost of sea freight is high and there is little effort to organize backhaul. The problem with air freight is essentially one of availability. Lack of volume means that charter planes must stop in neighboring countries, resulting in delays and deterioration of the quality of perishables.

Foreign exchange

Although exporting firms are now permitted to retain all of their earnings as foreign exchange deposits within Ghana, they are sometimes under pressure from commercial banks to convert some of their deposits into cedis, often at relatively unfavorable rates of exchange.

Labor laws

Few problems have been encountered with business registration procedures or labor regulations, though this is at least partly because firms tend to employ temporary labor as much as possible to avoid costly compliance with labor laws. Not all firms are aware of the income tax benefits that are available to them if they export.

Access to duty-free imported inputs

A duty drawback system is in effect for imported intermediate inputs, but it is complex and hardly ever used. Duty exemption is sometimes authorized, especially for the larger firms, but there is lack of transparency regarding the criteria used, resulting in considerable potential for abuse.

Administration and firms

There appears today to be relatively little arbitrary interference by officials at high levels in the activities of business firms. Where such interference has occurred, it has been strongly opposed by the private sector, often with success. In any event, the situation appears to be much better today than it was a few years ago.

ii. Horticulture

Across the board, horticultural exporters generally have the same characteristics and complaints. They are young firms, geared primarily to the export market. Their sales range from 30 to 300 million cedis. The firms in the sample operate between 15% and 54% of capacity. Ironically, most say that their capacity is inadequate to fill orders, but interest rates are considered too high for expansion, even if financing were available. This industry, in comparison to the others, seems much more sensitive to interest rates. Currency received from exports is almost completely converted to cedis in order to pay bills and interest charges, and to finance the next shipment.

Firms complain consistently that there is no agent on the receiving side of the shipment to verify the true amount of damage. One firm states that because 30-40% of each shipment is considered damaged, it is not worth expanding. With respect to transportation, limited air cargo space means that products have to be stored in cold storage, which is costly and can result in spoilage.
One of the largest horticultural firms has invested heavily in communications and has solved the problem of air cargo space by purchasing its own cargo plane. Through vertical integration of production, packing, and transportation, this company has reduced some of its major risks. Furthermore, because this company is represented at the receiving end, it has no complaints of false claims against damaged goods. Few firms, however, can achieve this scale of operation.

Yam exporters comment that government intervention was detrimental at one point. This was in 1990, when the government mandated that they could only sell to three UK firms and at a fixed price, resulting in their having to break contracts with other clients and incurring substantial business losses. Eventually, the three UK firms went bankrupt and the yam exporters had to re-establish client ties under conditions of lower credibility.

iii. Marine Products

Marine products are similar to each other in that their market is primarily the United States and they are either large-scale producers or small firms. Similar to the horticultural sector, older firms tend to be larger. However, firms that are subsidiaries are geared almost exclusively to export regardless of age. Due to the high fixed costs associated with large-scale fishing, the firms in this industry tend to be large. Those that are small are mainly brokers who buy from local fishermen, but, without the economies of scale, they tend to be less profitable unless they are able to specialize in a niche market. One highly profitable firm, for example, buys sharksfin, a delicacy item in East Asia that appears to also be popular in Ghana, from local fishermen. The sharksfin is salted and seasoned, adding value to the primary product. In this niche market, the small scale of operations is just as, if not more, profitable than those of large trawlers. At the other extreme, the tuna companies tend to be large, to receive substantial financing from external sources, to have significant economies of scale, and to have considerable bargaining leverage with the government. When fuel prices went up in January 1993, several of these companies complained enough that the government lowered the prices.

iv. Garments, Textiles, Accessories, and Handicrafts

Similarly to the horticultural industry sector, this sector seems to be doing quite well, and there is a general desire to expand production and exports. Unlike the marine industry, which imports most of its inputs duty free, these firms face high import tariffs (10-25%) on their imported inputs. Firms that act as a middleman, purchasing from small-scale artisans, seem to be more profitable than those that produce the goods that they export.

Although there is some complaint of initial difficulties finding markets, once these are found, the major problem is meeting market demand. Finance is a major issue. Due to unreliable local supply, companies must maintain high inventories to meet export orders. With working capital only available locally at high rates of interest and for short periods of time, producers must often set up an arrangement with the buyers for prepayment. Letters of credit are difficult to get approved and processed -- one firm was still waiting for an LC after 5 months. Lack of financing for fixed capital means firms have to work with old, out-dated machines whose spare parts must be imported or custom made, causing further constraints and delays in production. Other constraints include lack of technical assistance and a shortage of qualified workers.

v. Furniture and Wood Products

The furniture and wood products industry appears to be only modestly competitive under current circumstances. Under the Timber Export Development Board (TEDB), exporters must pay the same price for export quality wood that foreign customers pay. Pricing is in dollars converted to cedis at the current exchange rate. Most furniture makers cannot afford to buy the quality wood and therefore say that they cannot compete on the international market. In addition, the TEDB requires exporters to go to the Forest Product Inspection Bureau in Takoradi to receive permission to export, thus requiring the time and expense to go back and forth in order to complete an hour's worth of paperwork. This is evidenced by the firms' consistent complaints of cumbersome export procedures. Sometimes ships are missed due to paperwork, delaying product arrival for 2-3 weeks.

Another major hindrance is the banking process -- one firm said that it took seven months for the bank to confirm a letter of credit. In addition to having to wait for financing, firms have to pay their taxes in advance. No firm has ever received a duty drawback, though most have applied and have eventually ceased attempting. However, furniture firms do not appear to pay high taxes on their imported inputs. Firms did not seem constrained by market size, and all of them ship whole containers. Other constraints include lack of qualified, affordable personnel at all levels and expensive telecommunications.

2. Regression Analysis

For the sample as a whole, exports average 41% of total sales. In general, the smaller firms tend to be more specialized in producing for the export market, while the larger firms produce both for the domestic market and for export. Furthermore, with value of sales held constant, firms in the primary sector tend to export more than firms in the secondary sector. Each of these findings is confirmed by the following regression:

$$LNEXP = \underset{(.472)}{1.965} + \underset{(.460)}{.995}DPRI + \underset{(.088)}{.418}LNSALES \qquad R^2 = .447$$

where LNEXP is the natural logarithm of the value of exports;
DPRI is a dummy variable = 1 if the firm is in the primary sector;
LNSALES is the natural logarithm of the value of total sales;
R^2 is the coefficient of determination adjusted for degrees of freedom.

Figures in parentheses are the standard errors of the regression coefficients. If we were to subtract LNSALES from both sides of the equation, the left-hand side would equal LN(EXP/SALES) and the coefficient of LNSALES on the right-hand side would equal -.582, which is significantly negative and reflects the extent to which the ratio of exports to sales decreases as the value of total sales rises.

One reason for this may be the fact that the larger firms are significantly older than the smaller firms, as shown by

$$LNSALES = \underset{(71.907)}{207.607} - \underset{.036)}{.103}YREG \qquad R^2 = .152$$

where YREG is the year in which the firm was first registered. The older firms are more likely to have been established to produce first for the domestic market and subsequently for export as well; the younger firms tend to be established with the export market principally in mind. Attempts to test the independent influence of YREG on LNEXP were inconclusive, however, suggesting that this effect, operates primarily through the spillover of total sales by larger firms onto the export market.

Overseas markets are concentrated in Europe, the United States, and West Africa. Twelve firms export to the United Kingdom, 7 to Germany, 13 to the rest of Europe, 13 to the United States, 11 to West Africa, and 5 to other areas. Horticultural products, wood products, handicrafts, and textiles and garments are exported mostly to Europe and the United States; tobacco goes to the United Kingdom; marine products are exported primarily to the United States, and cola nuts, salt, oil palm, and other manufactured products are exported principally within West Africa. Contrary to what was expected, firms exporting to the West African market actually have significantly larger total sales and employment than do firms that do not export to this market. Yet there is little difference in the mean value of exports between the two groups. This suggests that most regional trade occurs as sales of the larger, older firms spill over beyond national boundaries, while the smaller, younger firms find niche markets outside of Africa.[23]

[23]This finding is consistent with the results reported in World Bank and USAID, *Building a Competitive Edge* ....

The constraint on nontraditional exports most frequently reported by firms is lack of capital for fixed investment. Nineteen out of 39 firms say that this is a major constraint. Yet many firms report low rates of capacity utilization, and the relationship between percentage utilization of capacity and lack of fixed investment capital, though positive, is relatively weak (t = 1.698). The hypothesis tested was that this constraint is more important for smaller than for larger firms, because of the lack of experience of the former in dealing with lending institutions, but total sales, exports, and employment are actually greater for firms that report this as a constraint than for the others. This supports the impression gained from informal interviews that the most important problems regarding nontraditional exports are on side of production rather than demand. Firms frequently state, in fact, that they have far more orders than they can fill.

Smaller firms are often forced to use their own capital because they lack the volume of shipments necessary to make profitable use of traditional instruments of trade finance such as letters of credit. Among the sample firms, 19 have financed their exports through overdrafts or loans backed by letters of credit (LCs) , 7 have obtained financing from overseas importers, 12 have used their own funds, and 4 have obtained financing from other sources. The mean value of exports for the firms that have obtained letters of credit is 358 million cedis, whereas this value is 187 million cedis for firms that have not obtained LCs. Despite this difference in mean values, however, the variances are quite large and the difference is not statistically significant (t = 1.11).

The next most frequently cited constraint is lack of overseas markets (9 firms) or lack of knowledge of these markets (4 firms). This constraint does not seem to be related in any way to size of firm (t = .28 for sales, t = 1.14 for exports, t = .42 for number of employees). On the other hand, those firms that export to the West African market are significantly larger (t =2.56 for sales, t = 2.26 for number of employees), but are not especially oriented towards exports (t = .21 for exports).

D. Comparative Cost and Incentive Analysis

1. Methodological Approach

Indicators of domestic resource costs (DRC), nominal rates of protection (NRP) for outputs and inputs, effective rates of protection (ERP), and effective rates of subsidy (ERS) were calculated applying the standard methodology and using data acquired in the second part of the survey. These indicators were then adjusted for institutional costs that were identified and measurable.

Most of the adjustments involved calculating the implicit export tax rate that results from (1) the imputed cost of unnecessary labor involved in processing export shipments, (2) the unnecessary cash costs involved in processing exports, including fees paid to organizations which rendered no services, and (3) the cost of having to convert 65% of foreign exchange earnings through the banking system rather than through the foreign exchange bureaus. Since most firms reported their export sales revenue in cedis converted at the bank rate of exchange, this value was adjusted upward to take into account the value of foreign exchange on the forex bureau market. The labor and cash costs associated with complying with unnecessary procedures were subtracted from the cost of nontradables.

An implicit tax on imported imports was calculated on the basis of (1) the imputed cost of unnecessary labor involved in processing import shipments, (2) the unnecessary cash costs involved in processing imports, and (3) the imputed capital costs resulting because of delays in processing imports. These costs were subtracted from the cost of nontradables and were considered instead as a tariff equivalent on imported inputs.

2. Results

The results of the analysis are shown by product line in Table II-1, which presents the comparative cost and incentive indicators both with and without the costs and disincentives introduced by the institutional constraints discussed above. The table shows the total value of export sales (for 1992, generally), the implicit export tax rate resulting from institutional barriers (the explicit export tax being zero), and the DRCs, NRPs on outputs and inputs, ERPs, and ERSs.

The wide range of scale of operations is evident from this table. The largest export sales, made by an oil palm firm, comprised 3.8 billion cedis. At the other extreme, the exports of one of the garment firms totaled only 1.1 million cedis. There is no significant relationship between the value of export sales and the other variables in the table.

The implicit export tax rates resulting from the institutional barriers cited above are not huge, but they are nonetheless significant. Each of the firms for which cost data are available is penalized by at least 2.9% of the FOB value of its export sales because of these barriers. In some cases, the cost is much higher, rising to a maximum of 16.2%.

TABLE II-1
COMPARATIVE COST AND INCENTIVE INDICATORS

Product	Export Sales Adjusted (000s cedis)	Implicit export tax rate	DRC	Adjusted DRC	NRP output	Adjusted NRP output	NRP input	Adjusted NRP input	ERP	Adjusted ERP	ERS	ERS
Pineapple	23111	3.1%	1.26	1.21	0%	-3%	5%	5%	-4%	-9%	-8%	-13%
Pineapple	134151	4.9%	1.05	1.00	0%	-5%	10%	10%	-5%	-12%	-9%	-15%
Oil Palm	3825000	3.0%	1.08	1.05	0%	-3%	9%	9%	-5%	-9%	-7%	-11%
Leaf tobacco	356800	6.2%	1.29	1.22	0%	-6%	18%	19%	-7%	-15%	-9%	-16%
Shellfish	47300	2.9%	0.81	0.79	0%	-3%	11%	11%	-6%	-11%	-9%	-13%
Tuna	961119	2.9%	1.14	1.10	0%	-3%	22%	22%	-16%	-20%	-18%	-21%
Tuna	1144875	2.9%	0.74	0.73	0%	-3%	19%	19%	-5%	-8%	-6%	-9%
Jams	18350	7.8%	0.74	0.67	0%	-8%	23%	23%	-5%	-14%	-5%	-14%
Furniture	1400000	3.9%	0.92	0.89	0%	-4%	27%	27%	-13%	-18%	-16%	-21%
Wood products	225000	16.2%	1.15	1.02	0%	-16%	20%	20%	-5%	-24%	-9%	-25%
Garments	1127	8.1%	0.47	0.41	0%	-8%	18%	18%	-5%	-15%	-12%	-21%
Garments	10000	7.2%	0.17	0.12	0%	-7%	39%	39%	-10%	-19%	-11%	-19%
Handicrafts	99270	8.8%	0.84	0.77	0%	-9%	31%	31%	-6%	-16%	-6%	-15%
Mats/Carpets	264000	6.9%	0.69	0.61	0%	-7%	36%	36%	-30%	-40%	-30%	-40%
Aluminum products	354445	15.0%	0.69	0.47	0%	-15%	7%	7%	-6%	-34%	-12%	-37%
Stationery	266218	7.7%	0.64	0.51	0%	-8%	18%	19%	-24%	-39%	-27%	-46%
Gas products	6087	10.8%	0.34	0.22	0%	-11%	19%	19%	-11%	-27%	-11%	-27%

Note: DRC - Domestic resource cost
NRP - Nominal rate of protection
ERP - Effective rate of protection
ERS - Effective rate of subsidy

These implicit taxes must be considered in the light of several factors related to exports. The first is that, in contrast to import-competing industries, nontraditional export markets are highly competitive. Over the longer run, there is very little fat in the cost structures of most products. Competitiveness depends on keeping costs to a minimum. An equivalent export tax of 5% to 15% can be critical to whether an industry survives. Second, there is already a substantial bias against exports in Ghana because import tariffs result in substantial protection for the import-competing sector vis-a-vis exports. They also cause the cedi to be overvalued, biasing incentives against both export and import-competing activities in favor of the nontradables sector. These biases are unavoidable in Africa today because of the difficulty of collecting a substantial portion of public revenue from direct taxes, but they make it imperative that all other impediments to export trade be minimized.

The DRC results suggest that most of the products being exported are profitable (DRC<1), and some of them are highly so. This is especially true after adjustment is made for the cost of institutional constraints. These adjustments include: (1) correcting the value of export sales for undervaluation due to the lower rate at which 65% of export earnings had to be converted from foreign exchange into cedis, and (2) subtracting out the costs of labor and capital associated with institutional constraints that can be removed.

Examples of profitable or nearly profitable exports include pineapples, shellfish, tuna, jams, furniture, wood products, garments, handicrafts, mats and carpets, aluminum products, stationary, and gas products. The pineapple company that is not profitable and shows a relatively high DRC has just started operations, so its unit costs should come down in the future. The other pineapple exporter, on the other hand, has been in the business for a long time so that its DRC probably is a reasonable approximation to that of the entire industry. Because the DRC is so close to one for pineapples, and probably other horticultural products, there is a need to watch costs carefully so as to maintain international competitiveness vis-à-vis numerous other suppliers. The same applies to a lesser extent to exports of shellfish and tuna.[24]

Among industrial goods, Ghana appears to have a significant comparative advantage in processed foods, such as jams, which contribute value added to primary production. Furniture and wood products are also reasonably profitable, but costs can be an important consideration, as shown by the fact that for wood products the unadjusted DRC is substantially greater than one while the adjusted DRC is almost equal to one. Garments and handicrafts are rapidly growing industries for which exports are very profitable and should be strongly encouraged. Other products such as mats and carpets, aluminum products, stationary, and gas products are quite profitable at present, but, because their major market has been the CFA countries, there may be some decline in their exports following the devaluation of the CFA franc in January 1994.

Other export producers are having a tougher time, e.g., oil palm, leaf tobacco. In some instances, high DRCs may be the result of transitory events, as when a new firm is just starting up, but in other cases it appears to be due to fundamental factors shaping the structure of comparative advantage. For example, it is unlikely that Ghana will be able, in the foreseeable future, to produce very profitably oil palm products for export. For one thing, agro-ecological conditions in West Africa are not as favorable for oil palm as in

[24] The tuna exporter in Table III-1 with the DRC greater than one was going through a transition period in 1992 and is probably much more profitable today.

southeast Asia, which is Africa's strongest competitor. For another, the oil palm industry was established as a substitute for imports, and it is not always easy to turn such an industry around to export. Finally, the major market for these exports has been in the CFA countries, and this market may diminish following devaluation. The leaf tobacco industry may also be experiencing agro-ecological difficulties, but more needs to be learned about the problems that this firm faces. What is perhaps most surprising, however, is how few unprofitable export industries there seem to be.

Since there are no formal export taxes, the nominal rate of protection for output is zero in each case. This is then adjusted for the implicit export tax rate to obtain the adjusted NRP, which is less than one, showing a disincentive to export on the output side ranging from -3% to -16%.

The unadjusted NRP for inputs is positive and much higher, ranging from 5% to 39%. This is because there is no workable system in effect to exempt producers of nontraditional exports from paying taxes, either directly or indirectly, on imported intermediate goods and on nontradable inputs such as electricity and transportation. Unlike the producer of import-competing products, the exporter receives no positive protection to compensate for this negative protection the use of inputs. The NRP for inputs is quite high for leaf tobacco, tuna, jams (processed foods), furniture, wood products, garments,[25] stationary, and gas products industries, rendering these less competitive. The adjusted NRP, which also takes into account the disincentive that results from the labor and capital tied up in clearing imported inputs, differs little from the unadjusted NRP.

The net result of all of these factors is relatively high negative adjusted rates of effective protection and effective subsidy. The adjusted ERP, for example, varies from -8% in the tuna industry down to -40% for mats and carpets. It is highly negative for leaf tobacco, unprofitable tuna, furniture, wood products, garments, handicrafts, mats and carpets, aluminum products, stationary, and gas products. The value of this indicator depends mostly on the importance of institutional constraints affecting output incentives, the weight of imported inputs in total production, and the rate at which inputs are taxed. With few exceptions, the table suggests that exports are heavily penalized by a combination of institutional constraints and taxation of imported inputs. This is in strong contrast to import competing products, which undoubtedly have ERPs that are substantially in excess of one. The adjusted effective rate of subsidy, though slightly different in magnitude, paints a very similar story. Thus the bias against nontraditional exports is very important and needs to be taken into consideration in policy discussions.

E. Policy Conclusions and Recommendations

The analysis of the survey data, coupled with the earlier description of the institutional environment, enables us to draw a number of policy conclusions. Foremost among these is the fact that a combination of taxation of imported inputs, either directly or indirectly through taxes on the tradable content of locally supplied inputs, plus the cost of various institutional constraints, results in a substantial disincentive to production for export. Adjusted effective rates of protection range from -8% to -40%.

[25]The difference in the NRP on inputs for the two garment firms is due to the fact that one uses mostly imported cloth (the one with the higher NRP) while the other purchases a substantial amount of its cloth on the local market. The two types of cloth are not identical, so the local cloth is treated as a nontradable in the analysis.

Given that most import competing activities have effective rates of protection that are positive and substantially above zero, this implies a very large bias against exports.
Removing as much of this bias as possible should be a major policy priority.

Many new entrants into the nontraditional export field have little experience with exports and frequently are in need of assistance in learning about the various administrative procedures involved. Beyond this, however, even the older, more experienced exporters incur significant costs in complying with these procedural requirements. The result is a significant barrier to exports. The following specific requirements seem to be questionable, based on experience in other countries:

1. The gaining of commercial bank approval of the A2 Form and the charging the exporter 1% or more of the FOB value of exports for processing the form and handling the foreign exchange transaction is difficult to justify in light of the movement towards a unified, flexible exchange rate. Data requirements can be satisfied if the firm simply submits the form to Customs at the time that the goods are cleared for export.

2. Membership in the Ghana Shippers Council should be optional and should not be a requirement for exporting.

3. The requirement that exporters of furniture and wood products obtain the approval of the Forest Products Inspection Bureau serves no reasonable purpose and imposes a very large burden on exporters of these products. It should be eliminated. The same recommendation applies to the need for handicraft exports to be approved by the Museum and Monuments Board.

4. The requirement that exporters and importers should obtain an Income Tax Certificate each time that they send or receive a shipment should be eliminated.

Duty-free access to imports used in the production of exports

Some way must be found to improve duty-free access by exporters to imported intermediate inputs. This is the second important area in which incentives are biased against exports. Bonded warehouses may work for some of the larger firms, but smaller firms are much less able to take advantage of this mechanism. The establishment of a special fund to be used to pay duty drawback may help, but procedures need to be simple and the process efficient. The building up of a set of coefficients indicating the indirect as well as the direct content of imported inputs in the exported goods would be highly desirable. Consideration should also be given to providing tax exemptions for imported inputs at the time of importation based on each firms export performance in previous years. This could be combined with the duty drawback system so that the firm could still claim a rebate for duties and taxes paid on imports im excess of the exemptions received and on inputs purchased locally.

All of this will require an efficient system of record keeping by individual firm. The basis for this system already exists in the Automated System for Customs Data (ASCUDA), which has recently been made operational at Tema, Takoradi, and the airport at Accra. This system maintains individual firm records that can be used to verify which duties and taxes have been paid, which exemptions have been received, and what each firm has imported and exported. Most of this information will be required anyway once the value added tax is introduced.

Streamlining import and export procedures

While the average delay in clearing exports through the ports or airport may not be excessive, some firms do experience excessive delays and the time required for clearing imported inputs is definitely too long. Reducing these delays has been an important factor in Asia in increasing export competitiveness. In Singapore, the introduction of Electronic Data Interchange (EDI) at the port reduced customs clearance time to 15 minutes. Computerization could have a similar effect in Ghana. This is only one element in the overall need to improve quality and timeliness.

Greater communication and simplification of existing incentives for firms

A number of firms appear to be either unaware of export incentives that are available or they are unwilling to use them because of the complicated procedures involved. The former is true of the partial income tax rebate, while the latter occurs with the duty drawback scheme and sometimes with the sales and excise tax exemption. It is important that export incentives be simple and transparent if they are to be used, especially by smaller firms. They also need to be widely publicized.

The same is true of approvals for investment code status and land registration. Although steps are being taken to simplify the approval process under the new investment code and to make the Ghana Investment Center more promotional and less regulatory, it is as yet unclear how effective these efforts will be. As far as land registration is concerned, there is great need for much better publicity regarding the steps to be taken since registration may require up to two years or more and mistakes can be very costly.

Availability of short- and long-term finance

The most important constraint noted by the firms in the survey is finance, especially for fixed investment. Firms frequently state that they have more orders than they can fill. This constraint exists for all sizes of firms. Although substantial progress has been made in recent years in restructuring the banking sector and in making more working capital available, little has been done to increase the availability of capital for renewal and expansion of plant and equipment. The situation is aggravated by the government and central bank issuing bills and bonds that carry very high rates of interest (up to 35%) and are the preferred investment for many financial institutions. This area deserves high priority. The establishment of the Eximguaranty Company and the Ghana Leasing Company may be steps in the right direction.

Lack of working capital is also likely to become an increasingly important constraint as the nontraditional export sector expands. This is especially a problem for smaller firms. Measures must be taken to assist these firms in applying for loans from the commercial banks. The opening of the Export Finance Office and the Exim Guaranty Company should aid banks in extending the range of their pre- and post-shipment financing to at least some of the smaller firms.

Labor market and regulations

Lack of sufficient skilled workers also appears to be a problem, the solution to which will require innovative training programs. These programs should be managed by the private sector, which understands best what specific skills are required. Some public subsidization of the programs would be desirable because the firms running the programs are not able to capture all the benefits.

The requirement to go through the Ministry of Labor for the recruitment of labor is onerous and discourages the hiring of workers on a permanent basis. Instead workers are hired temporarily to avoid this requirement and the problems and expense involved in retrenchment. It is recommended that the requirement for firms to go through Public Employment Centers when hiring workers should be eliminated and that they should instead be required simply to inform the Labor Office of the hiring of new employees. It is also recommended that labor disputes and the retrenchment of workers, when necessary, be settled within the context of collective agreements and that parties have access to courts for settlement of differences.

Contract enforcement

Contract enforcement is a significant problem since the judicial system, which is slow and costly, is rarely used for the resolution of disputes. This undoubtedly inhibits the establishment and growth of firms, which must depend on informal means of enforcement, but to what extent is unclear. Insofar as contracts with overseas importers are concerned, there is a need to explore alternative means of contract enforcement, such as use of surveyors and factoring agents, and to ascertain the degree to which these alternatives are cost effective. Efforts to assist firms in establishing linkages with foreign partners would also alleviate the problem of contract enforcement overseas.

Transportation

The cost and availability of sea and air freight depends very much on the volume of exports. Reducing sea freight costs will require greater volume and taking better advantage of potential backhaul rates. Larger volume would also lower air cargo rates by allowing cargo planes to ship full loads from Ghana.

Telecommunications

Telecommunications is a major problem both within Ghana and with other countries. A major overhaul of the system is planned, but in the meantime companies may want to take advantage of cellular phones and other systems which do not depend on central telecommunica-tions infrastructure. This is a very important priority for improving quality and timeliness of delivery. *Relationships between the administration and firms*

Few firms mentioned any instance in which there was arbitrary interference by officials in high places in the firm's activities. Although this problem is not unknown, it does not appear to be a major impediment to the growth of nontraditional exports. Certainly the situation is much better today than it was a few years ago.

A fair, transparent and predictable legal and judicial environment

On the other hand, it is clear that the legal and judicial system that underlies commercial dealings in the industrial world plays a much less important role in Ghana, and probably in the rest of Africa as well. Firms have to depend to a much greater extent on their personal experience, on the reputation of firms with which they enter into business dealings, and on the family and other social ties that enable to exert some control over the fulfillment of business obligations. Although not widely perceived by firms as being an important constraint in Ghana today, the lack of a well functioning legal and judicial system is likely to become increasingly important as the scale of activity increases and as business dealings become more impersonal. Furthermore, the current system works very much in favor of the larger firms and inhibits the growth of smaller, more dynamic enterprises.

III. MADAGASCAR CASE STUDY

A. Background

Madagascar was chosen as the second country for testing the methodology used in the study for two reasons. First was the comprehensiveness of its economic reform. The national investment program of the 1970s (known as *investir à outrance*) had been financed largely through external borrowing rather than internal savings. The result by the early 1980s was a large balance of payments deficit and spiraling inflation. This situation spurred the Ratsiraka government to launch a series of measures in 1982 which were designed to stabilize the economy and prepare for structural adjustment. Improving demand management through control of the budget deficit and restrictions on bank credit was accompanied by reform measures on the supply side, the centerpiece of which was the liberalization of rice marketing.[26] Reform continued throughout the 1980s and included devaluation, elimination of import quotas, abandonment of most export taxes, privatization of the financial sector, establishment of a new investment code to attract foreign direct investment, and the creation of a *Zone Franche* to promote exports.

Second, Madagascar is poised for strong export growth. Its comparative advantage on world markets stems from a wealth of natural and human resources. Its varied ecological and geological conditions and its southern hemisphere location give it a strong comparative advantage in a variety of niche products in the agricultural, livestock, marine, forestry, and mining sectors. The labor force is also relatively inexpensive. Table III-1 provides data on the average monthly wages, valued at official exchange rates, for several export sectors in Madagascar as well as a number of other countries. The data clearly indicate that even compared with some of its African rivals, Malagasy labor costs are extraordinarily low, providing a strong incentive for the production of labor-intensive products for export. If valuation were to occur at the new exchange rate after the FMG was floated in May 1994, labor costs would be lower still.[27]

[26] Democratic Republic of Madagascar (DRM), *Policy Framework Paper 1990-92* prepared by the Malagasy authorities (in collaboration with the staffs of the World Bank and the International Monetary Fund), May 23, 1990; Clive Gray, J. Dirck Stryker, and Jeffrey Metzel, *The Current Macro Economic Situation and the Progress of Economic Reform in Madagascar,* Prepared for the U.S. Agency for International Development, HIID and AIRD, January, 1991.

[27] Following the move in May 1994 to a floating Malagasy franc, with the exchange rate determined through interbank buying and selling each day, the FMG depreciated from about 1900 FMG/$US to about 3500 FMG/$US.

It is clear that the international business community is responding to these incentives. New investment and the increase in the number of new enterprises since the passage of the investment code and *zone franche* legislation has been marked. Investments under the Code have increased from an estimated FMG 23 billion in 1990, when the Code was passed, to 81 billion in 1992.[28] The number of enterprises obtaining *Zone Franche* status increased from 11 in 1990 to 53 in 1992. Many of these firms have generated employment for hundreds of Malagasy citizens.

TABLE III-1
COMPARATIVE MONTHLY WAGE RATES

		Local Currency	U.S. Dollars
Madagascar (FMG 1992)			
Manufacturing		57,700	$ 32
Agro-industry		73,000	41
Forestry		83,300	46
Mining		76,300	42
Other Countries (nonagricultural wages, 1990)			
Ghana (1988)	(cedis)	21,411	105
Kenya	(shillings)	3064	134
Malawi	(kwacha)	177	65
Mauritius	(rupees)	3252	219
South Africa	(rand)	1654	639
Costa Rica	(colones)	24,776	271
Canada	(Canadian dollars)	2019	1731

Source: AIRD estimates for Madagascar from enterprise survey; 1993 ILO Yearbook (wage data); IMF, International Financial Statistics (nominal exchange rates).
Note: Wages are converted to U.S. dollars at nominal exchange rates.

According to data available at the "*Banque des données de l'état*", nontraditional exports witnessed a moderate expansion until 1992, followed by a sharp decline. Much of this decline can be attributed to the political uncertainty of the period from mid-1991 until the end of 1993. Of greater interest are some of the product trends, especially if we ignore the last two years of political uncertainty. Among the products showing strong upward movement from 1989 to 1991 are dried beans, butter beans (*pois du cap*), luxury rice, sisal, cotton fiber, cocoa, live cattle, meat offals, shrimps, other seafood, canned fruits and vegetables, petroleum products, wood products, garments, and other products, which have done quite well since this period. There are products in which Madagascar would appear to have a significant comparative advantage and in which most investments are being made.

[28] Ministère de l'Industrie et de l'Artisanat, Direction de l'Industrie, 1993.

Despite these successes, the mixed record on nontraditional exports overall, including very poor performance in some sub-sectors, raises questions regarding the constraints that these exports are experiencing. Partly, the poor performance is due to the fact that some of the more dynamic industries, such as the labor-intensive garment industry, are not yet important enough in the figures to influence substantially the overall level of exports. But there are also more basic problems of poor transportation and telecommunications infrastructure, long distances from major markets, high freight rates, and lack of linkages between overseas markets and domestic production. In addition, there are numerous institutional constraint associated with administrative processing of exports and imports, controls on exporters' use of foreign exchange, implementation of duty and tax exemption schemes, access to financing, labor regulation, contract enforcement, and any number of other areas related to export trade.

The remain part of this section is organized as followed. Section B outlines the salient features of the legal, regulatory, and judicial environment, as well as other constraints, in Madagascar affecting exporters. The next section provides some details of the sample, reports statistics for the key variables in the survey, discusses qualitatively some of the problems highlighted by the survey, and presents the results of the econometric analyses. Section D presents the indicators estimated for the comparative cost and incentives analysis, showing indicators for each firm before and after accounting for institutional costs and distortions. Section E fills out the data analysis with case studies, revealing both the economic promise and the institutional burdens of firms operating in Madagascar. Section F draws some research conclusions and underscores the limitations of the methodology. The subsequent section outlines implications for policy. Finally, section H suggests areas of future research.

B. Institutional Environment

1. Special Incentives

Many exporting firms in Madagascar fall under one or both special incentive programs that are available: the *Code des Investissements* and the *Zone Franche*.

a. Code des Investissements [29]

The *Code des Investissements* (or "Code") was created in 1989 to encourage investments in the private sector. The primary goals of the Code are (1) to encourage the creation of new enterprises, (2) to promote expansion, quality improvements, and business diversification of existing enterprises, and (3) to encourage rehabilitation projects.

Under the Code, a broad range of industries and investment activities may be awarded preferential status.[30] These include handicrafts, manufacturing, mining, energy and water, transportation, veterinarian services, medical care, housing, land development, agriculture, livestock, forestry, crafts, fishing, shipping, and telecommunications. The range of activities and sectors encompasses almost all investment activities, but particularly those which contribute to the economic and social development of Madagascar.

All firms qualifying under the Investment Code pay a minimum 10% import tax on equipment, materials, construction materials, factory accessories, office materials, and information necessary for the implementation of the investment project. They are exempt from the payment of the *taxe unique sur les transactions* (TUT).[31] These reductions and exemptions only apply to those purchases made specifically for the investment project.

Small and medium-sized businesses receive preferential treatment over larger firms. To receive status as a *Petite et Moyenne Enterprise*, the firm must have fixed assets of less than or equal to 500 million FMG and labor costs of less than or equal to 25 million FMG.[32] The major difference in benefits between small and medium firms and other firms is the percentage of tax reductions received, and the duration that the firm receives them. Benefits apply for 10 years for investments aimed at establishing an enterprise, and for 5 years for investments aimed at expansion or rehabilitation. All small and medium-sized firms receive exemption from the *taxe de publicité foncière* on loans for applicable investments, as well as on guarantees for credits from foreign sources.

For investments leading to the creation of a new enterprise, small and medium firms receive total exemption on import and sales (TUT) taxes related to the use of working capital for up to three months; exemption from the *taxe professionnelle* for the first five years; exemption from the real estate registration fee for applicable real estate; and total exemption on taxes on profits and income for the first five fiscal years, with reduced rates for the next five. For small and medium firms investing in expansion, quality improvement, or diversification of activities, the following benefits apply: reduction of taxes on

[29] Because of its many inefficiencies and biases, the *code des Investissements* has been abolished in April 1997 and the *droit commun* is under revision to include many of the incentives featured under the *code des investissements* such that all firms are given the same incentives.

[30] Ministère de l'Industrie et de l'Artisanat, *Code des Investissements*, République de Madagascar, December 1992.

[31] See the discussion below on how the TUT has changed recently.

[32] These amounts are revised annually to account for the change in the foreign exchange value of the franc Malgache; these figures pertain to 1991.

profits and income equal to 75% of the amount invested; exemption from the real estate registration fee; and exemption from contribution fees.[33]

Larger firms, not qualifying for *Petite et Moyenne* status, also receive benefits according to investment goals. Benefits apply for 8 years for start-up enterprises and 5 years for expansion, quality improvement, or diversification investments. New large firms receive exemption from import and sales (TUT) taxes related to the use of working capital for the first three months of operation; exemption from the real estate registration fee; 50% reduction in contribution fees; 100% exemption from profit or income tax for the first five years, and a continuous reduced rate for the next three years; and exemption from the *taxe sur la publicité foncière* on bank loans and credit guarantees.

For investments in expansion, quality improvement, and diversification, large firms receive a reduction of taxes on profit and income equal to 75% of the amount invested; a 50% reduction in real estate registration fees; a 50% reduction in contribution fees; and a 50% reduction on the *taxe sur la publicité foncière* on loans and credit guarantees.

For rehabilitation projects, both small and large firms receive the reduction of taxes on profits that is incorporated in the general tax code. Large firms also receive a 50% reduction on the *taxe sur la publicité foncière* on loans and credit guarantees. Small firms automatically have this benefit.

As part of their requirements for continuance in the program, all firms must submit semi-annual reports on the progress of their investments. After the start-up phase for new investments, the enterprise must submit other reports and documents to the authorities which ensure compliance with the agreement. Experience with the Code has revealed its complexity and the long length of time needed to comply with all of its procedural requirements. Major problems have been experienced in obtaining *cartes de séjour* and employment authorizations, in different interpretations of the Code by different ministries, and in insufficient diffusion of information regarding availability of and criteria of eligibility for financing. The establishment of a *guichet unique* in 1994 could facilitate the approval process or it could simply add another layer of bureaucracy.[34]

Because of the difficulty of ensuring that the tax benefits associated with Code status are not abused, the Code is being modified to allow firms to receive these benefits only after the investments have been made. Upon presentation of documentary evidence regarding the investment, firms will be eligible to receive tax refunds in the form of reimbursements, transfers, or credits against current or future taxes owed. It remains to be seen whether this legislation will be enacted and, if so, how effectively it will be implemented.

b. Zone Franche

[33] The Code does not resolve a problem in investment laws dating to 1972 which distinguish between resident foreigners and non-resident foreigners, limiting business expansion severely for non-residents.

[34] Cabinets Madeleine Ramaholimihaso Manamihaso, "Le Guichet Unique," *Bulletin de Reflexion, d'Information et d'Etudes Financières, Comptables, Juridiques, Fiscales, Economiques*, No.39, March 1993, pp.15-16.

Created in 1989 and amended several times since, the *Zone Franche* (the "Zone") is designed to encourage exports and foreign investment. Zone firms fall under one of four types of enterprises: 1) promotion-exploitation enterprises (EPE), which are firms responsible for management and construction work; 2) manufacturing firms; 3) service firms; and 4) firms developing primary resources. Technically, firms are supposed to be located within a geographic *Zone Franche Industrielle* (ZFI) determined by local and regional governments. However, for practical purposes, Zone firms may be located anywhere with local approval; the "Zone" is a legal concept, not a geographic one.

To qualify for the *Zone Franche*, firms must fulfill certain criteria. An EPE must be able to prove its technical and financial capacity to contribute to the development of a ZFI. Manufacturing firms must devote their entire production to exports and satisfy particular criteria according to specific sectors. Service firms must also "export" their products, i.e. provide services only to foreign entities or to other Zone companies.

The main fiscal benefits and regulations for the Zone include tax holidays, customs concessions, and special privileges with respect to maintaining foreign exchange accounts.[35] First, all firms in the *Zone Franche* are subject to a fixed 10% IBS, or corporate profits tax (*impôt sur les bénéfices des sociétés*). However, EPE firms are exempted for a period of 15 years, manufacturing and primary resource firms are exempted for 5 years, and service industries are exempted for 2 years. After this grace period, firms receive a reduction on profits taxes equivalent to 75% of their new investment. Second, all firms are subject to a fixed tax of 10% on distributed dividends. Third, EPE firms who supply their own network for electricity, water, or telecommunications are exempted from the sales tax and the *taxe unique sur les transactions* (TUT). Finally, there is a 35% tax rate ceiling on expatriate salaries.

Zone firms also receive special customs concessions. Inputs for the construction, preparation, or implementation of an enterprise in the *Zone Franche* are exempted from custom duties, other import taxes, sales taxes, and the TUT. Goods and services exported from a *Zone Franche* firm are exempted from all export duties and taxes.

All benefiting companies may take on international loans and are allowed to maintain bank accounts outside the local banking system, a significant benefit in light of the restrictions forbidding Malagasy businesses from doing so. All firms are required to open a special account in FMG at one of the country's commercial banks. The law permits repatriation by foreign firms in the Zone of amounts equal to deposits made in foreign exchange (but denominated in FMG). Banks are required to maintain foreign exchange reserves at the Central Bank sufficient to guarantee that hard currency will always be available for repatriation. In fact, in a situation where capital in a firm is entirely owned by non-resident foreigners, the total amount of the initial investment and the initial working capital must be covered by the foreign exchange reserves of commercial banks.

2. Droit Commun

In areas not covered by these special incentive regimes, or where firms have not been granted the benefits of the regimes, the *droit commun* applies. This comprises the laws, decrees, and other legal instruments that constitute the overall legal and regulatory environment.

[35] Ministère de l'Industrie et de l'Artisanat. *Regime de Zone Franche,* Republique de Madagascar, December 1992.

a. Land and Property Rights

One of the major shortcomings in Malagasy legislation is the inability of foreigners to own land. In legal terms, this shortcoming is the result of a *note de service* issued by the *Ministère de l'Interieur* taking functional precedence over a constitutionally guaranteed right of ownership by foreign nationals. This *note* has been buttressed by a sequence of proclamations by the Ministry of Interior and individual public officials forbidding foreign ownership.[36] This legal anomaly deters foreign capital investment, forcing business people to secure long-term leases for property underlying whatever infrastructure they wish to develop. The process of land rental by foreigners includes a requirement of authorization by the Ministry of Interior, and leases may be written for up to 50 years.

Even for Malagasy nationals, however, land titling is not an easy process. The Ministry of Interior in 1991 estimated, in light of the lack of a comprehensive land survey, that of the country's more than 58 million hectares, 2 million are held under community property ownership, 3 million are in individually titled land (including corporate ownership), and the balance of more than 53 million remains state-owned property.[37] The process through which nationals may acquire title is an egregious one, reportedly consisting of dozens of individual legal steps hampered by continual delays in processing.

b. Labor

The World Bank noted in 1991 that a number of Malagasy regulations hamper the efficient functioning of labor markets, including limitations on mobility and regulations governing the closing of businesses or the discontinuance of certain business activities.[38] Certainly, the Code and Zone legislation attempts to remedy some of these problems through language that exempts qualifying firms from meeting these requirements in the event of ceasing operations. However, no firm in the survey noted labor regulation as a burden to efficient business practice. In some cases, this was because firms employ workers on a short-term basis in order to avoid complying with labor regulations.

There are clearly documented limitations on the ability of firms to hire foreign nationals (some of which are lightened for Zone and Code firms), and it is virtually impossible for foreign nationals to obtain Malagasy citizenship. Foreigners must obtain a working permit from the Ministry of Labor if they themselves are to launch a business, or their Malagasy employers must seek authorization from the Immigration Service within the *Ministère de la Fonction Publique, du Travail et des Lois Sociales*.[39]

---

[36] As recently as 1992, the Prime Minister stated, "*Ce sont les investisseurs qui m'interessent.... Cependant, qu'il n'y ait surtout pas de spéculations: Les Malgaches tiennent à leur terre*" Madagascar Tribune, 14 August 1992, p. 7, cited by Hilton Root, *Environment for Investment in Madagascar: Institutional Reform for a Market Economy*, Center for Institutional Reform and the Informal Sector, University of Maryland, February 1993, p. 17.

[37] Interviews with the Ministry of Interior, April 1991.

[38] World Bank, *Madagascar: Beyond Stabilization to Sustainable Growth*, draft, 1991.

[39] Roland Marie Rasoamanarivo, *Lois, règlements, procédures et documentation relatifs aux exportations*, Projet MAELSP/USAID, p. 12.

c. Capital

In the late 1980s, the government initiated a significant financial liberalization program after a decade of heavy state intervention. This program included the opening of the banking sector to private capital in 1988; progressive liberalization of interest rates, which since November 1990 have been fully liberalized; and a move away from direct to indirect instruments of monetary control, which has not taken place.

Despite these reforms, Madagascar's financial sector faces major difficulties. The country has one of the lowest savings rates among developing countries and its financial depth, measured by the M2/GDP ratio, is also among the lowest. The M2/GDP ratio was stagnant between 1968 and 1988, remaining below 25%.[40]

Part of the lack of financial depth can be explained by the fact that Madagascar is one of the poorest economies in the world. However, there are a number of other factors reinforcing this trend. Although nominal interest rates are determined freely by commercial banks, real interest rates for short-term deposits are often still negative.[41] The financial system is biased toward short-term financing with little medium or long-term finance available. High rates of inflation and fluctuations in the real exchange rate in the past have led to a general distrust among economic agents concerning the attractiveness of holding financial assets. As a result, savings in real assets are, for most savers, more attractive and less risky than lending to the financial sector. Furthermore, Madagascar's financial network is concentrated in the urban areas, thereby failing to capture the surplus resources of the rural sectors. The majority of the population finds it difficult to gain access to financial assets in the formal financial sector. This is due to the nature of its activities, which are mostly agricultural, and the small size of enterprises.

The financial system also does not function efficiently because of the inadequacy of the financial infrastructure needed for intermediation and provision of payments services.[42] There is a general lack of adequate financial information on lending terms and credit risks, and financial transactions are not performed in a timely and secure manner. There is lack of legal protection for lenders as well as borrowers. The legal system is perceived as outdated -- the Commercial Code dates from the colonial era. The machinery of justice is slow, ineffective, and unreliable. These inadequacies have led to a pattern of finance in which transactions are limited to short-term securities and to borrowers who are personally known to the lender or able to provide easily attachable collateral. As a result, exporters rely heavily on self-financing from the informal sector, which places severe constraints on the scope and nature of their trade.[43]

---

[40] World Bank, *Madagascar: Financial Policies for Diversified Growth*, A World Bank Country Study, Washington: 1993, p. 18.

[41] Manfred Zeller, *International Finance And Food Security In Madagascar*, International Food Policy Research Institute (IFPRI), draft, May 1993, p. 6.

[42] Zeller, *International Finance* ..., p. 39.

[43] Zeller, *International Finance* ..., p. 7.

However, with emerging liberalization of the financial sector, Madagascar should become increasingly eligible for supplier financing. Foreign banks, including offshore banks, could provide trade finance for both imports and exports. The recourse to offshore banks has already been useful for exporters operating under the Zone. In addition, pre-shipment finance, especially for intermediate inputs, is likely to become more important as the world market begins to appreciate the reputation of Malagasy exporters. Presently, there is reluctance on the part of financial institutions to intervene at the pre-shipment stage because there is a significant element of risk that final production, and hence payment, may not materialize. Banks are worried that their funds may become tied up for too long and without any guarantee.

Enlarging pre-shipment finance will require increased synergy between (a) foreign manufacturers and exporters of intermediate goods and (b) exporting enterprises. Export credit guarantee schemes (ECGS) could also be an important mechanism through which exports could be promoted. Experience shows that ECGS could become important for exports after nontraditional exports attain a certain minimum level. Once Madagascar succeeds in diversifying its export market, with products sold in markets characterized by greater risk, an ECGS will become crucial. This is not yet the case.

d. Access to Foreign Exchange

The financial sector liberalization of 1988 permitted importers to request and receive any amount of foreign exchange and to seek financing through any means for imports, including their own resources, suppliers' credits, or loans from the banking system. Despite this liberalization, foreign exchange access has been limited both by the government's method of valuing the FMG and by strict regulations on who can hold foreign exchange and under what circumstances they may hold it.

An overvalued exchange rate played an important role in Madagascar's trade imbalance throughout the 1970s and early 1980s. Due to a combination of high inflation and a fixed nominal rate of 50 FMG to the French franc -- a rate that had been applied since Madagascar left the franc zone in 1973 —- the Malagasy franc appreciated in real terms by 26% between 1977 and 1982, reducing the competitiveness of Malagasy exports on the world market and making imports relatively cheap. In 1982, as part of the stabilization program, the government began a series of nominal depreciation against the French franc, although import quotas remained largely in place both before and after the devaluation took place.

In 1983-84, the focus of the reform program shifted from stabilization to structural adjustment, as the government became aware of the need for fundamental reform of price and trade policies. Decontrol of post-factory prices and profit margins and removal of export taxes on the vast majority of goods in 1984-85 was accompanied by replacement of official maximum prices for paddy by floor prices in order to promote private marketing of rice.[44] Import liberalization followed in 1987, accompanied by a major devaluation of the Malagasy franc (58% against the SDR).

[44] Paul A. Dorosh, René E. Bernier, and Alexander H. Sarris, *Macroeconomic Adjustment and the Poor, The Case of Madagascar*, Cornell Food and Nutrition Policy Program Monograph 9, Ithaca, New York: December, 1990, p. 54.

The cumulative effects of exchange rate movements were mitigated by pent-up demand under price controls and trade restrictions until the late 1980s and by continued inflation through the end of the decade. The major devaluation of 1987 was followed by a managed float policy through which the government allowed the value of the FMG to float against other major currencies within some predetermined range. The agreement with the IMF also called for the introduction of an open general licensing system of foreign exchange allocation through which importers could obtain foreign currency at the prevailing exchange rate and finance the purchase through a source of their own choice. The system applied only to importers of goods, not services. The OGL system remained in place until 1991, when the policy changed again in the aftermath of a run on foreign currency by importers, which drained national reserves to a few weeks' worth of imports by the end of 1990. Instead of allowing the FMG to depreciate, however, the Central Bank severely tightened credit controls and its allocation of foreign exchange.

Until recently, Malagasy exporters were required to deposit 100% of their foreign currency receipts at commercial banks, which held 60% in accounts at the Central Bank and turned in the remaining 40% to the Central Bank. The 40% portion was used for debt financing and imports by the government of energy and other commodities priced in hard currency. The 60% portion represented reserves against which importers could draw on an as-needed/as-available basis. Importers who were not exporters faced severe constraints on their ability to gain access to foreign exchange, and the rules restricting access by exporters to a maximum 60% of their receipts (and often less given the demand for foreign exchange) created an incentive for clandestine off-shore trading of FMG for hard currency.

The cost to exporters of this policy increased during the early 1990s as the FMG became increasingly overvalued due to inflation, pent up demand for imports, and other factors. In May 1994, however, the government abandoned its policy of trying to manage the exchange rate and allowed the banks to buy and sell currency at whatever exchange rate they chose. The average bank rate was published each day, and this rate was to be used for transactions smaller than 20,000 FF. As a result the rate moved relatively quickly from about 320 FMG/FF to 560 FMG/FF. At the same time, exporters were allowed to retain 10% of their foreign exchange earnings, with the goal of moving towards 100% retention as circumstances permitted. This was a first step towards implementation of *Loi No. 91-014*, passed by the *Assemblée Nationale* in late 1991, which was to enable exporters to retain a portion of their earnings outside of Madagascar. Final enactment of the law was contingent on a ministerial decree that was never issued.[45]

With the exception of the 10% retention, Madagascar maintains the requirement for Malagasy exporters that foreign exchange proceeds should be repatriated and surrendered in exchange for local currency. Although the cost of this policy is less than it was in the recent past, it is not zero and there is presently no adequate mechanism for exchange rate risk coverage for exporting enterprises.

It is instructive to compare this system with that which exists in Mauritius, where the government has managed its foreign exchange system quite flexibly, allowing exporters to retain foreign exchange balances in diverse currencies with domestic commercial banks so as to meet their foreign exchange

[45] Cabinet de Conseille d'Entreprises, *Projet de Promotion des Exportations Agricoles, Rapport sur l'Aspect Juridique et Réglementaire*, draft, February 1993.

commitments on imports.[46] This system has helped the enterprises to offer coverage against exchange rate fluctuations. In addition, it has enabled them to generate income from foreign exchange management.

e. Import Taxes and Procedures

In the 1970s, the Malagasy government strengthened import prohibitions and quantitative restrictions. By 1986, quantitative restrictions applied to all imports, and imports of goods produced in Madagascar were totally prohibited. The tariff structure was quite complex and discriminatory. There were 60 different tariff schedules ranging from 0% to more than 1000%, resulting in high effective protection for some sectors and products.[47]

In 1987, the government initiated the liberalization of the import sector. All non-tariff barriers to imports were eliminated and a 30% surcharge was introduced on some previously prohibited imports in order to ease adjustment in the sectors concerned, primarily textiles and meat. This surcharge was reduced to 10% in 1989 and was eliminated in 1990. Tariff variance was reduced by lowering the number of rates from 69 in 1987 to 14 in 1990, and by limiting the rates to multiples of five between a minimum of 10% and a maximum of 80%.[48] This marks a substantial improvement over the prior byzantine system of import bans and taxes, but the system still remains complex and expensive with respect both to taxes and procedures.

i. Import Taxes

The *Loi de Finance* for 1992, the year to which the survey in Madagascar applies, provides details of tax rates applicable to every type of imported good. Four separate taxes rates were involved, including the *droits de douanes* (DD), the *taxe d'importation* (TI), the *taxe de consommation* (TC), and the *taxe unique sur les transactions* (TUT). Each of these applied to the CIF value of imports, except the TUT, which applied to the CIF value plus the sum of the other three taxes paid. The list of goods was exhaustive, requiring 319 pages of the *Journel Officiel*, and rates varied markedly according to product and purpose. For example, the TI alone was 50% for mineral water, 45% for cut flowers and edible nuts, 40% for various spices, 35% for crustaceans and other types of seafood, 10% for chemicals and chemical derivatives, 30% for plastics and polymers in various forms, 15% for skins and leathers, and 25% for finished clothing.

While there appeared to be a certain pattern of higher rates for goods that are produced or producible in Madagascar than for goods that must by imported, this characterization was not uniform, nor was there any evidence of generally higher rates for finished goods versus intermediate inputs or for luxury goods versus necessities: eyeglasses incurred a TI of 40% while golf clubs were taxable at 25%. As an example of the byzantine nature of the import tariff schedule, the law stipulated that imports of canvas pieces for shoe manufacture were subject to a DD of 35%, a TI of 5%, and a TUT of 5% (they

---

[46] World Bank, *Financial Policies...*, p. 197.

[47] World Bank, *Madagascar: Financial Policies ...*, p. 19.

[48] Rasoamanarivo, *Lois, Règlements...*, p. 16.

are exempt from the TC), but sheets of canvas weighing 400 grams or more per square meter were subject to 0% DD, 40% TI, 5% TC and 15% TUT.[49]

Taken together, some intermediate inputs could become prohibitively expensive when all of the various duties were added together. For instance, the total tax burden on imports of cotton fabric amounted to 70%, the same rate as for finished clothing. In fact, a typical Malagasy manufacturer of clothing competing with *Zone Franche* industries in the same sector would have needed to pay duties at an unweighted average of 45% for the basic inputs such as cotton material, thread, sewing machines, needles, washing machines, and packing material.

In recognition of the complexity of this system, a number of significant modifications are in the process of being made. First, the TUT, which has alternated between being a value added tax and a turnover tax, has been combined with the *taxe de consommation* and became a straightforward turnover tax called the *taxe sur les transactions* (TST). This tax is scheduled to become a value added tax (VAT) in the near future. Second, a subsequent *loi de finance* was issued in late 1992 that greatly simplified the import tax structure. This law established the following rates for the combined DD and TI: raw materials 10%, intermediate products and basic final products 20%, ordinary final products 30%, semi-luxury final products 40%, and luxury final products 50%. The top three rates are to be collapsed into a single 30% rate by a *loi de finance* to be voted on in 1994.

Despite these reforms, the rate of taxation on many imported inputs can be quite high. For example, most of the inputs into the garment industry are taxed at a combined DD/TI rate of 30% because these can be considered as basic finished products as well as intermediate inputs. Adding the basic VAT (now TST) of 25% times the CIF value plus import duties, one arrives at total tax on these imports of 62.5%. This high rate of duty on imported inputs used in the production of exports makes it imperative that a viable system for duty-free admission of these imports be put in place.

ii. Import Procedures

The procedures governing imports also increase transactions costs. These procedures require that goods are met by a personal representative of the importing company at the point of disembarkation. Customs clearance is reportedly often a matter of negotiation rather than standard procedure; it requires a myriad of certifications, goods identification, and securitization of property. The procedures have proven to be so onerous that the government agreed after a year of negotiation with importers to pass along a large portion of the work of customs clearance for imports to a private firm, Veritas, which certifies that actual shipments conform to invoices and import documents.

A large part of the problem in streamlining import procedures is the discretionary authority of customs officials in delaying delivery of goods for purposes of verification and payment of appropriate duties. While the Veritas system has aided in avoiding fraud in the form of under- and over-invoicing, the system remains hostage to a large number of regulations that must be enforced by a small number of customs agents. These agents have the power to disrupt the flow of goods and physically open containers

[49] GDRM, *Journal Officiel, Loi de Finances*, July 27, 1992, p. 1322.

for verification of contents at any stage of the process of importation. While import and customs taxes are not paid directly to agents, but rather to banks which then provide written confirmation that must be furnished to customs, agents do have an incentive to delay clearance and could potentially profit personally from cash bribes and other *cadeaux* to speed the process. However, there is no evidence that this type of activity constitutes a major cost to importers. While several exporters reported paying tips of one kind or another to customs agents, the amounts were paltry and paled in comparison with the cost of delays in delivery of key inputs.

The delays in obtaining clearance of imports range from a few days to many months, according to the firms surveyed. Inclusion in the *Zone Franche* (ZF) does not insulate firms from this type of delay. One firm reported that every shipment of imported inputs requires detailed chronicling of quantity and price, and proof of exemption of these imports from import tax. This firm reported that delays in confirming this information and processing forms took an average of two weeks per shipment between the arrival of the goods in Madagascar and clearance for delivery to the firm. Delays for firms that are not classified under the ZF were far longer, in some cases stretching up to several months. Filing the paperwork alone would sometimes require several days.

Part of the problem has been due to the range of tax rates mentioned above. However, even simplification of the tariff structure will not solve the problem cited as most important among the factors constraining the customs service from efficient operation: lack of personnel. The *Direction des Douanes* reportedly employs 750 customs agents to administer all of the traffic across borders, including people and goods. There are insufficient personnel even to monitor the industries within the *Zone Franche* to ensure that imported intermediate inputs exonerated from import tax are actually reexported. The solution probably lies both in simplifying export and import procedures and reducing the number of approvals required and in increasing the resources and efficiency of the customs service.

iii. Duty-free Admission of Imported Inputs

Several mechanisms already exist for the duty-free admission of imported inputs, as well as for other tax exemptions on the inputs used in producing exports. Each of these has its disadvantages.

Zone Franche

The tax exemptions of the *Zone Franche* are the most comprehensive and easily implemented. Since the Zone does not comprise a specific geographical area, however, problems of monitoring and enforcement arise, especially for smaller firms to which a customs agent cannot be permanently assigned. Furthermore, although Zone status is open to all firms that export close to 100% of their production, in practice only those that are of a certain size apply and are approved. In addition, the benefits are not available to firms that produce partly for the domestic and partly for the export market. Thus Zone status tends to be highly discriminatory.

TUT Exemption and Temporary Admission

Firms that export more than 75% of their total production are eligible to be exempted from the TUT paid on locally purchased imports. This requires approval by the Directeur des Impôts each time that these purchases are made. All firms are eligible for temporary admission, without payment of import duties, TUT, etc., of imported inputs used in the production of exports (*régime suspensif des droits)*.

This procedure is used mostly by the larger exporters. It poses significant problems of monitoring and control. All of these procedures are subject to abuse in the form of tax evasion, discretionary approvals open to corruption, lack of widespread publicity, and time-consuming steps required for approval.

f. Export Taxes and Procedures

i. Export Taxes

Formal export taxes were practically eliminated in September 1988 (*décret* no. 88-015 01.01.1988). Although legal irregularities remain with respect to the procedural elimination of export taxes, as well as many of the regulations governing exports,[50] only vanilla remains subject to an export tax.

ii. Export Procedures

The 1988 *décret* also simplified many of the procedures faced by exporters. The law eliminated the requirement of an export card, as well as quality checks for all exports except of meat and seafood.

However, legal simplification of export procedures has not led to practical simplification. The *décret* was not successful in relieving exporters of requirements that can be numerous and cumbersome depending on the nature of the product to be exported. While the legal underpinnings of these requirements may be suspect, since the 1988 law formally abrogates all pre-existing regulations at the same time as it leaves some discretion to individual ministries, the practice of customs agents requiring approval for exports by one or more ministries is reportedly common.

Every exporter is required to obtain a *Domiciliation Déclaration Exportation et Engagement de Répatriation de Devises* from his commercial bank, at a cost of up to FMG 5000. Generally exporters reported that banks furnished this documentation in a half-day or less. Completion of the *Déclaration des Douanes (Serie E)* is also required of all exporters, and this procedure requires more time since the form asks for detailed descriptions of what is being shipped. Phytosanitary inspection and approval by the Ministry of Agriculture is required for exports of meats and fish, and safety inspections of agricultural produce is legally optional but sought by exporters who wish to reassure their clients of quality control. Other optional clearances include certificates of origin issued by the Chamber of Commerce, certificates of quality control in packing, certificates of merchandise traffic for goods headed to the European Community (issued by banks and used by only a few exporters), and exit authorization by the Ministry of Commerce (used by almost no one in the survey).

Other requirements apply on a product-by-product basis, and their application is rife with irregularity and subject to the discretion of ministry and customs authorities.[51] For example, export of any

[50] Christopher L. Shaw, J. Dirck Stryker, and Louis Aucoin, "Costs and Benefits of Removing Institutional Constraints on Nontraditional Exports: Madagascar Case Study, Associates for International Resources and Development, June 1994, Annex A.

[51] It is not clear whether the Ministries in these cases are implementing a unilateral *note de service* or are operating on the basis of practice dating to before the 1988 *décret*. What is clear is that application of these procedures is clearly in conflict with the spirit and the letter of the 1988 legal reform, and clarification of these and other legal inconsistencies is fundamental to reducing the uncertainty faced by exporters.

artifact or handicraft that might hold cultural significance requires inspection and approval by the *Ministère de l'Industrie, Energie et Mines*, which also must approve any export of mined material, whether stone, gems, or minerals. Export of any wood product requires clearance by the *Direction des Eaux et Forêts* in the *Ministère de la Production des Animaux, des Eaux et Forêts*. Export of a wooden artifact, therefore, would require clearance by both ministries.

Delays vary widely from case to case. Some exporters report that their forms are processed quickly, within one day per ministry, while others experience delays ranging from two to ten weeks. Several business people complained of the lack of certainty surrounding export procedures, that some people appeared to receive unwarranted exoneration or special service as a result of personal relationships (not bribes, interestingly), that rules were in a constant state of flux, and that enforcement by customs agents was haphazard.

The actual cost of these delays is unclear since several exporters noted that export procedures in general were cumbersome but that costs incurred due to paperwork were minimal compared to customs delays and costs associated with limited shipping and storage capacity (see below).

3. The Judicial System

None of the firms surveyed mentioned the lack of an indigenous legal system of dispute resolution as a major constraint to the growth of trade. However, several recent reports have documented the inadequacies of the Malagasy judicial system with respect to commercial law, dispute resolution, competition law, and judicial independence.[52] Taken together, these reports paint a picture of the Malagasy legal and judicial system as so entangled in inconsistencies, ill-developed jurisprudence, and misplaced discretionary authority that it renders the system "ineffectual and unreliable."[53] Malagasy entrepreneurs and foreign investors are advised to stipulate in their contracts recourse to international arbitration rather than the Malagasy court system so as to ensure efficient and equitable resolution of conflict. Where parties must turn to the Malagasy courts to adjudicate disputes, the costs in time and wasted resources could well be considerable, even if the final outcome is satisfactory from a legal standpoint, a result that is far from guaranteed.

4. Other Constraints

Exporters in Madagascar must contend with other constraints, some of which are already well documented in the literature.[54] Decrepit transportation and telecommunications infrastructure, insufficient storage facilities, a monopoly on air cargo, a shortage of qualified labor, and lack of information on external

---

[52] They include Louis Massicotte, *Towards an Independent and Accountable Judiciary: Report on Judicial Reform in Madagscar*, Center for Institutional Reform and the Informal Sector (IRIS), University of Maryland at College Park, September 1993; Root, *Environment for Investment...*; Louis Aucoin, *Dispute Resolution as an Alternative to the Ordinary Courts in Madagascar: A Guide to Choice in the International Arena*, IRIS, October, 1993.

[53] Aucoin, *Dispute Resolution*, p. 1.

[54] J. Dirck Stryker, Jeffrey C. Metzel, Ashley S. Timmer, *Regional Specialization and Agricultural Growth in Madagascar*, AIRD, Cambridge, Massachusetts, January 1993.

markets are among the most egregious of these constraints. Each has some aspects falling under the institutional rubric.

a. Transport and Telecommunications

The road network in Madagascar remains in a deplorable state despite recent improvement in the primary road network, especially the major road link between the capital city and the port of Tamatave, the paving of which was recently completed. Some primary roads linking provincial capitals, most secondary roads, and virtually all access roads are impassable for many months of the year, severely limiting transport of goods to major points of departure.

The seaport capacity of Madagascar is also strained. While ocean transit is the transport of choice for most of Madagascar's exports, the two ports at Mahajanga and Toamasina are operating at their theoretical capacity and by 1995 will face a capacity constraint.[55] Projections for the smaller eastern and southeastern ports are more hopeful, but the costs of exporting are driven up in these cases by the need for lighterage, i.e. transferring goods from a quay to a smaller vessel, which then transfers the cargo to oceanliners waiting in deeper water. Lighterage costs are particularly high in the eastern ports because of exposure to heavy seas on the Indian Ocean side of the island; only the major eastern port at Toamasina offers adequate protection from weather. Also, the vast majority of cargo in Madagascar is transferred from truck or train to ship manually. When implemented, plans for port rehabilitation are likely to mitigate these high costs.

Among the most serious infrastructural shortcomings for exporters, especially since a majority of exporting companies are located in the capital region, is the lack of a freight terminal in Antananarivo. Many of the exporters interviewed remarked on the need for a terminal in the capital to provide a central location for storage and transfer of cargo among rail, truck, and air carriers; to act as a point of contact for consolidating shipments; and to serve as a collection point for available containers, of which there is a constant shortage. Smaller Malagasy exporters also lack cold storage at the airport, a fundamental component of successful trade in fresh produce, seafood, and meat.

The transport system in Madagascar suffers from inefficiencies created by the state monopoly over air cargo imposed by the government-owned airline, Air Madagascar. This monopoly results in prohibitively high air freight rates for exporters, who cannot afford to take advantage of the space that exists on Air Madagascar's (and Air France's) backhaul to Nairobi, South Africa, Reunion, and Europe. Many firms in the survey complained of high rates, unused space, and missed opportunities for markets abroad brought on by Air Madagascar's chokehold on the air freight market. Reports confirm this phenomenon, insofar as there is excess capacity on flights leaving Madagascar in all but the most intensive months of the litchi season.[56] While air cargo prices appear to be competitive on runs to and from Reunion, Air Madagascar rates to European destinations are 20 to 30% higher than rates for comparable runs from Nairobi on private carriers, though private carriers operating the Kenya-Europe route can charge somewhat less for reasons both of distance and of high back-haul capacity on a large number of

[55] Stryker, Metzel, and Timmer, *Regional Specialization*

[56] Charles Steedman, *Do Telecommunications and Air/Sea Transport Problems Limit Madagascar's Exports?* Center for Research on Economic Development, University of Michigan, January 1993.

commercial flights. Should the rates from Madagascar be lowered to more competitive levels, there would be a substantial increase in demand, which would soon require the use of cargo planes.

Sea shipping rates are higher from Madagascar to Europe than from Mauritius to Europe for reasons unrelated to restricted capacity or oligopoly.[57] While rates are roughly 30% higher for higher value products (such as sweaters) leaving Toamasina compared with St. Louis -- 1300 ECU per container from the Malagasy port compared with 1000 ECU from the Mauritian port -- the two ports operate at similar levels of efficiency. Although there are some pricing distortions due to historical pricing patterns and the nature of the public/private interface in freight management in Madagascar, the differential is due largely to structural and navigational problems in the Toamasina port which require capital investment for improvement. The Société Nationale Malgache de Transport Maritimes (SMTM) considers that shipping rates are quite competitive with the world market now and cannot be lowered much further, a claim that is supported by private shipping concerns such as the Mediterranean Shipping Company.[58] Therefore, the higher costs of shipping by sea should be considered a real cost of operating in Madagascar.

Telecommunications within Madagascar are very poor. Firms have great difficulty calling or faxing the airport or one of the ports from their farms, factories, or head offices. They frequently have to resort to sending messengers, which is costly, time-consuming, and contributes to traffic congestion. This impedes efficiency and makes timeliness and quality control difficult.

b. Labor

Several exporters remarked on the lack of skilled labor in Madagascar. With better than average levels of educational attainment and high unemployment, Malagasy workers work hard, work productively, and work long hours. Nevertheless, despite broad satisfaction with the general quality of labor, several exporters reported having trouble finding workers with the requisite skills and were forced to incur the costs of supplemental training. Several companies in the *Zone Franche* actually set up quite extensive training units to transfer specialized skills to their workers.

c. Market Information

Finally, Malagasy exporters face significant competition in international markets, especially with respect to high value products destined for Europe, Asia, and North America. Information on these markets and on the nature of the competition is poor, and connections to overseas distributors and potential foreign partners require substantial investments of time and capital. Despite the comparative advantage that Madagascar holds for supplying regional markets in southern Africa, especially in the wake of the democratization of South Africa, most of the economic activity within the private sector remains domestically oriented or oriented towards Europe.[59]

---

[57] Ibid, pp. 22 *et seq*.

[58] Ibid, p. 23.

[59] J.E. Austin Associates and Management Systems International, *MAPS Private Sector Survey: Madagascar*, prepared for USAID Madagascar, April 1991.

C. Survey of Nontraditional Exporters

Analysis of the survey of nontraditional exporters included two major steps. The first step, reported here, involved the identification of a number of key variables and the estimation of a series of regressions to reveal which variables are the most important in determining whether, and to what extent, institutional constraints are experienced by firms. In order to have the firms' perspective on the most critical constraints to nontraditional exports, a survey was administered, under sub-contract, to a sample of 34 exporting firms by *the Office Statistique et Informatique pour la Programmation du Développement (OSIPD)*. The information gather a the firm level was complemented by the existing literature on the subject and informal meeting conducted with policy makers and members of the research community. The second step, reported in the next section, consisted of the calculation of a number of indicators of comparative costs and incentives, with and without accounting for the costs of institutional constraints.

1. Characteristics of the Sample

a. Quantitative Description

The sample includes 34 firms, all of which export goods from Madagascar. The sample represents a variety of sectors, and includes firms exporting to a range of markets. Sectors represented include agricultural products (26% of the sample); garments and textiles (18%); marine products, processed foods, and miscellaneous manufactures (12% each); wood products (9%); and handmade artisanal goods and semi-precious stones (6% each). Thirty-nine percent of the sample exports 100% of production, and the rest export from 10% to 80% of production. Overall, exports average 59% of total sales. The percentage of firms exporting to each market is as follows: Europe in general (41%), the Indian Ocean (38%), France (35%), US (21%), Asia and Germany (15% each), other points in Europe (9%), Africa (6%—mostly South Africa), and the United Kingdom (3%). Many firms export to more than one region or country.

Firms vary greatly in size. Of the firms reporting total sales, 10% (3 firms) gross FMG 100 million or less in total annual sales (about $55,000 at the official exchange rate prevailing at the time), and 6% report sales falling between FMg 20 and 30 billion ($11 to 17 million). More than two-thirds of the sample (68%) falls in the 1 to 10 billion FMG range ($0.5 to $5 million).

As for the age of the firm, one-third of the sample registered officially with the *Registre de Commerce* during or before 1980, whereas 24% registered in 1990 or later. Capacity utilization was high, with 58% of the respondants to this question reporting 90% or higher utilization.

Over one-third of the sample (12 out of 31 firms) consists of labor-intensive enterprises, employing more than 100 workers per billion FMG in sales, while almost half (14 firms) employ fewer than 50 workers per billion FMG in sales. Interestingly, the garment industry, which is thought to be quite labor-intensive, covers a range from 15 to 258 workers per billion FMG in sales, though all of the garment/textile firms employ a considerable number of workers and together account for more than half of all firms employing 300 or more workers. All garment firms are either classified as *Zone Franche* enterprises or have access to duty and tax-free inputs under the TUT exemption and temporary admission procedures.

There is a negative correlation between exporters that are labor-intensive and those that are intensive in the use of natural resources or capital. One of the working hypotheses is that Zone firms, which often are established with substantial foreign capital, gain their competitive edge from low-cost labor and almost total reliance on imported inputs for raw materials and intermediate products. Those firms that are not in the Zone, on the other hand, are more likely to be of two types. The first is highly export oriented, but relies more on the natural resource base of Madagascar than on its pool of low cost labor. The second type of firm outside the Zone was established some time ago to produce for the domestic market and has only more recently begun to export. Often these firms were established behind protective trade barriers, so that they tend to be more capital-intensive and to have less of a comparative advantage in exports unless they have already made a successful transition away from their orientation towards the domestic market.

The major constraints facing exporters with respect to production and exporting finished goods include:

i. export procedures (16)
ii. access to capital for fixed investment (11)
iii. constraints on physical capacity and/or cost of transport off island (10)
iv. lack of working capital (6)
v. inadequate skill levels of labor (5)
vi. transportation infrastructure (5)
vii. inadequate product quality (2).

The survey reveals the following constraints facing exporters with respect to imported inputs (in the order of the frequency of their citation by firms):

i. import procedures (14 firms cited this as a problem)
ii. access to foreign exchange (13)
iii. transport capacity for imports (4)
iv. access to import financing (2).

It is noteworthy that no firm mentioned lack of markets overseas as a constraint on exports, and virtually every firm noted some form of foreign cooperation in the promotion of exports.

The rules governing Zone and Code firms, as opposed to Malagasy firms that do not qualify under either regime, appear to make a significant difference in the propensity of firms to experience institutional constraints to trade. This was borne out in subsequent analysis of the survey data.

b. Qualitative Analysis

The results of the survey cannot be described just in quantitative terms. Much of the information that was gathered from the exporters is better expressed qualitatively. In doing so, it is useful to make a distinction between the real cost of doing business in Madagascar's export trade and those costs that are amenable to policy change.

i. Real Costs

The surveys indicate that the real costs are formidable and derive from inadequacies in the domestic transportation and telecommunications infrastructure, lack of depth in the financial sector, and shortcomings of the judicial system. While these constraints can be altered over time, the process is likely to be a slow one and will require considerable investment.

Infrastructure

Infrastructural inadequacies were often cited in the survey as a sources of major costs and delays. Five firms mentioned transportation infrastructure explicitly as a major constraint to exports. For firms that collect products such as dried beans from the countryside, delays resulting from poor transportation mean the loss of a substantial competitive edge in overseas markets. Many firms related anecdotes during personal interviews that underscored the inefficiency inherent, for example, in relying on personal messengers for communication between the port of Tamatave and the capital city.

Financial sector

The lack of depth in the financial sector affects exporters with respect to both working capital and capital for fixed investment. Banks report broad use of letters of credit by exporting firms, an assertion borne out by the firms themselves. Smaller firms, however, are not always able to obtain LCs, or the cost may be too high in relation to the value of shipment. In other instances, goods are shipped on consignment, where LCs are not appropriate. Other forms of financing, including pre and post-shipment, are relatively rare. Businesses who have access to other forms of credit are generally limited to those with personal contacts or accounts abroad.

Lack of working capital was considered less of a constraint on exports than lack of capital for fixed investment. The high rate of capacity utilization and the expressed desire of many firms to expand is evidence of the lack of access by private firms to capital. The existing capital market does not allocate resources according to greatest need. Instead, ceilings imposed by the Central Bank on credit to the major commercial banks and lack of financial intermediation have forced private sector cooperatives and associations to create their own credit and financing mechanisms. These include FIVCAM, put in place by the business association FIVMPAMA (a Malagasy acronym for *Groupement des Opérateurs Privés Nationaux),* to which many of the exporters of nontraditional products belong; SIPEM created by GEM (*Groupement des Entreprises de Madagascar),* another business association counting among its members many of Madagascar's traditional exporters; FIARO, a capital risk and capital development fund; MADINVEST; and *Entreprendre à Madagascar*.[60] These organizations suffer from lack of resources, however, since they are dependent on members' contributions for their capital.

Judicial system

There is little evidence that firms employ the Malagasy court system to resolve commercial disputes. In those cases where Malagasy firms did report having suffered some form of injustice, whether imposed by a contracting party or by public authority, these grievances appear to have gone largely unheard in any forum. There is thus a disincentive to enter into any sort of business relationship in which the entrepreneur cannot bear the risk of large losses of orders or inventory. This is a real cost of doing business within the Malagasy economy, and can only be reduced through continued legal and judicial reform.

ii. Costs Amenable to Policy Change

[60] République de Madagascar, Groupe de Travail Technique, *Intégration Economique Régionale, Projet de Rapport Final*, November 10, 1992.

Respondents identified a number of costs that accrue to exporters that should be amenable to policy change. These included unnecessary fees and tips, lack of free access to foreign exchange, delays in obtaining clearance for entry of imported inputs or exit of finished goods, and high cost of transport for both imports and exports. Fees include the *taxe professionnelle* and the *patente d'exportateur*, paid annually; payments to a private forwarding agent (*transitaire*), usually equal to about 0.5% of the value of the imported or exported material; bank and customs fees; fees for certificates of origin, certificates of quality control in packing, certificates for goods destined for the European Union, and exit authorizations by the Ministry of Commerce; and fees charged for clearances by specific ministries. Not all of these fees are mandatory, and there is a broad variation among individual firms as to the amount paid and the extent to which these fees represent onerous costs to firms. Among non-Code, non-Zone firms, these fees ranged from 0.04% of total sales FOB to about 1%. As a group, however, fees for the non-Code, non-Zone firms represented a higher percentage of sales than did fees for firms under one of the incentive regimes. Since only Zone firms are formally exonerated from liability for the *taxe professionnelle*, Code firms also paid out considerable fees, ranging from 0.1% to about 1%.

Across the board, tips and other *gratuités* constituted a nearly negligible proportion of the total fees paid, falling in the range of FMG 10,000 to 50,000 per shipment.

Access to Foreign Exchange

Lack of access to foreign exchange was a frequently cited problem in the survey. Malagasy law prevents any national from holding a foreign exchange account at home or abroad.[61] As a result, exporters are required to convert their foreign exchange into FMG at whatever rate they can get from their banks. During the period of the survey, this rate was fixed by the central bank at a level that tended to increasingly overvalue the FMG, thus penalizing exporters. As a result, there was an incentive to underinvoice exports and to exchange foreign currency for FMG either offshore or on the local black market at a more favorable rate of exchange.

Customs and Shipping Delays

Costs associated with export delays varied widely according to the experiences of individual firms. Such costs include the costs of delays from customs clearance, as well as the delays associated with shipping. While some firms did not report bearing any additional costs associated with customs or shipping delays, others cited these as amounting to FMG 15 to 20 million ($8000 to $12,000), primarily from spoilage and lost or canceled orders, although the capital costs associated with delays could also be important. For several firms both in and outside the *Code des Investissements*, these costs amounted to 15 to 25% of total FOB sales.

Air and Sea Freight Charge

The survey results showed much higher cost of air as compared with sea freight. Also, substantial savings can be achieved on air freight charges by shipping in volume. Sea freight rates are assessed by container while air freight rate are determined by weigh. Furthermore, if air freight costs could be reduced by 20 percent by eliminating the existing monopoly of Air Madagascar/Air France, this

[61] This was changed in May 1994 to allow exporters to retain 10% of their earnings of foreign exchange.

would represent savings of about 2.4 FF/kg, or 3% of a product worth 80 FF/kg FOB. This is a considerable saving in a competitive export market.

Customs clearance

The financial burden of air freight premiums appears to be less than the burden due to delays in customs clearance, particularly for those companies exporting perishable items such as meats, fish, and other consumable. One company that exports high value perishable products to France reported that export delays could cost up to FMG 15 to 20 million per year, or about 15% of its value of total sales FOB. The costs of delays reported by other companies was in a similar range -- 3% to 10% of total sales. Another complaint voiced by even the *Zone Franche* firms is the lack of agents available for on-site customs clearance prior to packaging for shipment.

Part of the problem in customs clearance of food products is due to the nature of the product: while it is necessary to move the goods quickly, it is also essential to meet sanitary standards in order to protect not only the particular customer involved but also the international reputation of Malagasy exports. It is in these cases that the shortage of customs personnel and the need to prioritize shipments for their attention is most acute.

c. Prioritization of Institutional Constraints

The analysis of the survey results permits the a rough prioritization of institutional constraints according to their relative cost to firms. Table III-2 presents a ranking of institutional constraints, an estimate of their costs expressed as a percentage of total FOB sales, the type of firms that must incur these costs, and comments.

TABLE III-2
RANKING OF INSTITUTIONAL CONSTRAINTS

Rank	Institutional cost	% of sales FOB	Type of firm affected	Comments
1.	Foreign exchange access	3 to 10%	All firms	Cost dependent on
			firms outside the Zone.	extent of overvaluation. and ownership
2.	Customs clearance	0 to 25%	All firms	Affects Zone firms much less than other firms. Applies to both imports and exports, although delays to exports clearance related to lack of infrastructure as well.
3.	Air freight monopoly	0 to 8%	Perishable product firms	Limited to those firms able to use air freight.
4.	Fees	up to 1%	Non-Zone	Variable and dependent especially on ministerial clearances required.
5.	Tips	Negligible	All firms	

Note: Real costs of poor infrastructure, capital constraints, and unreliable judiciary not included
It should be noted that for those firms not included in the Zone or Code, import taxes would theoretically rank high on this list, depending on the reliance of a firm on imported inputs and the rate at which these inputs are taxed.

2. Regression Analysis

Regression analyses were run in order to discern the combined effects of different variables included in the questionnaire.

Industry type

Exports were run against a total of ten dummy variables indicating industry type. The only significant result occurred in the case of the garment and textile industry, as shown in the following.

$$LEXP = \underset{\substack{(0.34)\\ t=17.58}}{+6.05} \quad \underset{\substack{(0.77)\\ t=2.27}}{+1.75\,DIND8} \qquad \text{Adjusted } R^2 = 0.13,\ df = 28$$

where LEXP = natural log of total exports in millions of FMg;
DIND8 = 1 for garment or textile industry, 0 for other.

When the natural log of sales was introduced as an independent variable into this equation, however, the industry dummy variable was no longer significant. This is reasonable since most of the garment and textile firms are either in the *Zone Franche*, where most firms export 100% of their output, or they are owned by foreigners who have the export market primarily in mind. This becomes evident by looking at the following regression results.

$$DIND8 = \underset{\substack{(0.14)\\ t=3.46}}{+0.48} \quad \underset{\substack{(0.15)\\ t=-3.20}}{-0.47\,OWN1} \quad \underset{\substack{(0.15)\\ t=1.96}}{+0.30\,LEG2} \qquad \text{Adjusted } R^2 = 0.43,\ df = 25$$

where OWN1 = 1 for wholly Malagasy owned, 0 for other;
LEG2 = 1 for *Zone Franche* firm, 0 for other.

These results show that garment and textile firms tend to be foreign owned, included within the Zone, or both.

Ownership status

A two-parameter log function testing the impact of ownership status on exports revealed that wholly Malagasy ownership (as opposed to foreign-ownership and joint ventures) was significantly negative as a predictor of exports, suggesting that Malagasy businesses operate at a disadvantage compared with other firms.

$$LEXP = \underset{\substack{(0.55)\\ t=13.47}}{+7.46} \quad \underset{\substack{(0.67)\\ t=2.11}}{-1.41\,OWN1} \qquad \text{Adjusted } R^2 = 0.11,\ df = 27$$

This is true even if we correct for size by introducing sales into the equation.

$$LEXP = \underset{\substack{(1.52)\\ t=2.46}}{+3.73} \quad \underset{\substack{(0.61)\\ t=-1.91}}{-1.17\,OWN1} \quad \underset{\substack{(0.18)\\ t=2.61}}{+0.47\,LSALES} \qquad \text{Adjusted } R^2 = 0.27,\ df = 28$$

Legal status

As expected, legal status had a significant impact on the degree to which export procedures posed a constraint to trade. Those firms that do not benefit from the Code or the Zone are significantly more likely to report problems with exports:

XPRO1	=	+0.07		+0.35 LEG4	Adj
	(0.06)	(0.14)		df = 32	
	t=1.15	t=2.50			

where XPRO1 = 1 for firms citing export procedures as constraint to trade, 0 for other
LEG4 = 1 for firms that are neither Code nor Zone, 0 for other.

This was a considerably better predictor than Zone status alone, which yielded the following.

XPRO1 =	+0.62	-0.33 LEG2		Adjusted R^2 = 0.05
	(0.11)	(0.22)		df = 27
	t=5.73	t=-1.54		

However, holding sales constant, firms in the Zone had significantly greater exports than firms that were not in the Zone.

LEXP =	+1.48	+0.63 LSALES	+1.15 LEG2	Adjusted R^2 = 0.50
	(1.06)	(0.14)	(0.53)	df = 26
	t=1.39	t=4.46	t=2.18	

Labor Intensity

Tests were also conducted to see if exports were associated with the labor intensity of productive activities. This hypothesis was confirmed, even with sales held constant.

LEXP =	+1.77	+0.78 LSALES	+0.39 LEMPS	Adjusted R_2 = 0.32
	(1.35)	(0.20)	(0.20)	df = 28
	t=1.32	t=3.87	t=1.97	

However, neither Zone status nor ownership status was significantly related to degree of labor intensity.

Summary

These results indicate that:

a. garment/textile industries export more than other industries;

b. garment/textile industries tend to be foreign owned and to be included within the Zone;

c. firms that are 100% Malagasy owned export less than those that are foreign owned or joint ventures;

d firms that have neither Code nor Zone status experience more problems with export procedures than those that are included in at least one of these categories;

e. *Zone Franche* enterprises export more than enterprises in any other category, even if sales are held constant;

f. holding sales constant, firms that are more labor-intensive tend to export more. Many of these firms are in the garment and textile industry.

Thus we gain a picture of a dichotomy between foreign-owned firms, many of which have Code and/or Zone status, are strongly oriented towards exports, and suffer relatively few procedural problems, on one hand, and Malagasy-owned firms, with less access to the Code and/or Zone, with less of an orientation towards exports, and with more procedural problems in exporting, on the other hand. Although this distinction is not perfect, it nonetheless exists in the sample and should be a cause of some concern for policy-makers.

D. Comparative Cost and Incentive Analysis

1. Methodological Approach

Measures of comparative costs and incentives were calculated for each enterprise using a variation of AIRD's IMPACT template to measure nominal rates of protection for both outputs and inputs, effective rates of protection, effective rates of subsidy, and domestic resource cost coefficients. In each case, these coefficients were calculated and adjusted for institutional costs. These institutional costs were used to estimate an export tax equivalent for each firm, calculated as the sum of the unnecessary fees and labor costs associated with export procedures and the foreign exchange premium lost by having to convert foreign exchange earnings into local currency at the official, rather than the parallel, rate of exchange.[62] Dividing this by the FOB value of exports, expressed in terms of the parallel rate of exchange, we obtained the implicit export tax rate. Institutional costs associated with imported inputs were calculated as an implicit import tax. All these institutional costs were subtracted from total nontradable costs.

---

[62] For companies wholly owned by foreigners or for ZF companies, the foreign exchange loss was calculated only on the amount of foreign exchange required to be converted into domestic currency in order to pay local costs, since these companies are allowed to keep their export earnings in foreign exchange accounts. In cases where total sales included some portion of domestic sales as well as exports, calculation of coefficients assumed 100% exports, for purposes of comparison, unless cost figures were recorded exclusively with respect to exports.

The cost of converting 100% of foreign exchange earnings at the official exchange rate was estimated for firms owned by Malagasy citizens assuming no access to the parallel exchange market either in Madagascar or abroad. Firms owned by foreigners, on the other hand, were assumed to have access to such accounts, and to convert into local currency at the official rate of exchange only the FMG required to pay local costs. This overestimates the losses of these companies since most of them satisfy part of their local currency needs by converting offshore at the parallel rate of exchange. The institutional costs associated with loss of foreign exchange were estimated by calculating the difference between the amount of foreign exchange converted into FMG at the official exchange rate (1800 FMG/$US) and what that conversion would have yielded at the parallel exchange rate (2000 FMG/$US).[63] Excessive costs of the administrative procedures associated with exports and the importation of inputs were calculated either on the basis of what the firm reported or by estimating the costs of tied up labor and capital, beyond that which could normally be expected (3 days), plus unnecessary fees and excessively high tips. Among the labor, fees, and tips that were considered as unnecessary were those used to obtain the *Domiciliation Déclaration Exportation et Engagement de Répatriation de Devises*, the *patente d'exportateur*, and authorizations from technical ministries with the exception of those involving food products.

2. Results

The results of this analysis are presented in Table III-4. This table permits several conclusions, each of which must be tempered by the fact that the sample is neither random nor large enough to permit broad conclusions about exporters in Madagascar in general. Nevertheless, evidence pertaining to the firms surveyed is clear and highly suggestive of what is likely to be found for a broader sample of firms.

1. Of the 14 firms for which data were available to estimate comparative cost and incentive indicators, 7 firms have been approved under the investment code, 3 are in the *Zone Franche*, and 1 was wholly foreign owned.

2. The firms cover a range of sub-sectors including traditional exports of coffee and cloves; nontraditional agricultural, livestock, and marine products; processed foods; wood products; clothing; semi-precious stones; and miscellaneous manufactures. They also span a broad range of firm sizes.

[63] This parallel rate is the approximate rate in Madagascar at the time of the survey. It underestimates the rate that existed offshore, especially in view of the practice, *importation sans cession des devises*, which allowed importers to acquire foreign exchange. overseas without going through the banking system. Also, the parallel exchange rate was less than the free trade equilibrium, rate of exc hange because of the effects of import tariffs and other restrictions. The shadow exchange rate, used in the analysis to adjust world prices, was estimated at 2250 FMG/$, reflecting the assumption that the FMG was overvalued by 25% of the official rate of exchange. This was in line with the general level of import tariffs and with reasonable assumptions regarding elasticities of supply of exports and of demand for imports, but it probably underestimated the effect of informal quantitative restrictions on imports operating through the banking system, in view of the large depreciation that took place after the FMG was floated in May 1994.

3. The implicit export tax rate resulting from institutional costs varies from a low of 3.3% for a firm that has both Code and Zone status to a high of 37.8%, though this latter is exceptional since none of the other firms has an implicit export tax rate higher than 15%.[64] Nevertheless, 11 out of 14 rates are in excess of 10%, implying substantial export disincentives.

4. All the firms that were surveyed and completed this part of the questionnaire are operating efficiently by world standards (DRC<1). In a few cases, such as litchis/raphia, medicinal herbs, foies gras, pickles, and one garment firm, the DRC is very low, reflecting Madagascar's strong comparative advantage in these activities.

[64]The firm with an implicit export tax rate of 37.8% had a particularly costly experience because a technical ministry deliberately held up its approval in order to give a competitor an advantage. Although this was an unusual occurance, it indicates the risks that are involved when the government plays an important role in regulating private sector operations.

TABLE IV-4
COMPARATIVE COST AND INCENTIVE INDICATORS

Status	Product	Export Sales (000s FMG)	Implicit export tax rate	DRC	Adjusted DRC	NRP output	Adjusted NRP output	NRP input	Adjusted NRP input	ERP	Adjusted ERP	ERS	Adjusted ERS
C	Coffee/Horns	1724268	14.1%	0.53	0.49	0%	-14%	48%	48%	-4%	-18%	-4%	-18%
	Coffee/Cloves	3392193	10.0%	0.52	0.52	0%	-10%	47%	47%	-4%	-15%	-6%	-16%
	Litchis/Raphia	1500000	11.3%	0.26	0.24	0%	-11%	39%	50%	-2%	-14%	-2%	-14%
	Medicinal herbs	33000	37.8%	0.28	0.05	0%	-38%	13%	13%	0%	-39%	0%	-36%
	Cotton fibers	27000000	10.0%	0.88	0.87	0%	-10%	35%	36%	-5%	-16%	-6%	-17%
	Meat/Vegetables	2092528	10.4%	0.72	0.71	0%	-10%	44%	44%	-5%	-16%	-5%	-16%
	Marine products	1200000	10.1%	0.72	0.67	0%	-10%	11%	11%	-8%	-23%	-9%	-24%
C	Processed food	123566	11.9%	0.39	0.37	0%	-12%	30%	30%	-1%	-13%	-2%	-14%
ZF/C	Pickles	1200000	3.3%	0.30	0.29	0%	-3%	2%	2%	0%	-4%	-1%	-4%
C	Wood products	507500	13.4%	0.71	0.65	0%	-13%	37%	54%	-5%	-21%	-6%	-22%
FO/C	Clothes	2400000	9.5%	0.82	0.81	0%	-10%	49%	56%	-4%	-15%	-5%	-15%
ZF	Clothes	2163500	5.4%	0.46	0.46	0%	-5%	4%	4%	0%	-6%	-1%	-6%
ZF/C	Semi-precious stone	77740	11.9%	0.99	0.96	0%	-12%	27%	27%	-4%	-17%	-6%	-19%
C	Plastic bags	6175500	12.7%	0.70	0.56	0%	-13%	21%	26%	-21%	-44%	-24%	-46%

Note: DRC - Domestic resource cost
NRP - Nominal rate of protection
ERP - Effective rate of protection
ERS - Effective rate of subsidy

Status
C = Investment Code
ZF = Zone Franche
FO = Wholly foreign owned

5. Institutional costs have a significant effect on the DRC indicator. The average decline in the DRC coefficient across all firms is .045, once institutional costs are extracted from total costs.

6. The nominal rate of protection (NRP) is zero for all firms, given the lack of any explicit export taxation. The adjusted NRP on output varies from -3% to -14%, except for the one firm for which it is -38%. It is generally lower in absolute value for Zone firms. This suggests, as was supported in the regression analysis, that being in the Zone not only benefits firms insofar as duty-free inputs are concerned, but it also facilitates the clearance process and avoids them having to lose much on their conversion of foreign exchange.

7. The NRP on inputs varies from 2% to 48%. The lowest rates are for firms in the Zone.[65] Most other firms pay rates of duty on their imported inputs that total 25% or more. This is a major barrier to exporters of products that use substantial amounts of imported inputs in their production if the exporting firms are not within the Zone. The situation is even worse for most firms when institutional costs are taken into account. In a few cases, such as wood products, the institutional costs are very high.

8. The combined effects of negative protection on output and positive protection on imported inputs give rise to effective rates of protection that range from 0% to -21%. The negative ERP of -21% for plastic bags is a good example of what happens when a firm that uses substantial amounts of imported inputs -- in this case about one half of the value of production -- is not granted duty-free admission of these inputs. In other sectors, on the other hand, the share of imported inputs in the total value of production is relatively low, so that high rates of taxation of these inputs does not lead to very high levels of effective protection. This is particularly true of resource based industries. Effective rates of protection are especially low -- zero in this case -- for Zone firms that import most of their inputs since these are admitted duty free.[66]

9. Adjusting the EPC for institutional costs results in a substantial increase in the degree of negative protection. The range of the adjusted ERPs is -4% to -44%, with even the Zone firms experiencing some fairly substantial disincentives. The ESC follows a similar pattern. This is all the more serious when one considers that most import competing firms have positive rates of effective protection that are probably about 30% to 50% simply because of the level and structure of tariffs used for revenue purposes.

E. Case Studies

[65]The one exception to this is the firm that exports semi-precious stones. Unlike most of the Zone firms, which import most of their inputs, this firm purchases the bulk of its raw materials and other inputs locally. It does not pay taxes directly on these purchases, but it pays taxes indirectly on the inputs used to mine the stones, produce the electricity, and otherwise supply the goods and services that it purchases locally.

[66]Note that the *Zone Franche* firm that exports semi-precious stones and purchases most of its inputs locally has an ERP that is not very dissimilar from the ERPs of non-Zone firms.

To integrate the quantitative and qualitative analyses presented thus far, it is useful to look at case studies of individual firms. Although these are not representative, they provide some important insights.

Firm A: wood products
Code, joint venture, 50% exports, resource-intensive

Firm A was created in 1987 for the production of intermediate wood manufactures. It qualified in 1989 under the *Code des Investissements* as a joint Malagasy/foreign venture with an Asian partner, and it began to export to Asia and Mauritius. Exports are currently equal to approximately 50% of sales, which total about 500 million FMG. The firm is resource-intensive, relying on indigenous woods as major inputs. It is less labor-intensive than other exporters, employing 110 people in production and another nine in management. The firm is reliant on imports of production equipment and inputs such as wood paste.

The firm notes several major problems with respect to imports and exports. First, the managing director estimates that the costs of import procedures and delays annually in terms of production stoppages can equal up to FMG 100 million, or 25% of average sales. In calculating the various indicators, we have reduced this figure to 2.5% of sales, and it still has a big effect. These delays are due primarily to import delays of up to five months for shipment and customs clearance of equipment by boat, or 45 days by air. The firm reports that no local supplier carries the necessary inputs with sufficient reliability for its operation. Moreover, when local stores carry the equipment or supplies, the quality is inferior and the price exorbitant.

The firm estimates that export procedures require from 15 to 60 days to complete, and cost up to 2 million FMG per shipment. While the specific export procedures were not delineated, export of wood products requires notification of and approval by the Direction des Eaux et Forêts (DEF) in addition to regular customs procedures.

The firm is operating efficiently by world standards, with a domestic resource cost coefficient of 0.71, but it could be operating more efficiently with an adjusted DRC of .65. The firm's implicit export tax rate is relatively high at 13.4%, reflecting the fact that institutional costs pertain to export as well as import procedures. A fairly high nominal rate of protection of 37% on inputs indicates that the firm is being taxed by existing trade policies: the NRP increases with the inclusion of institutional costs to 54%. An effective rate of protection of -5%, measuring the incentives to producers that affect prices of both outputs and tradable inputs, reflects the fact that this producer receives negative protection, i.e. that he is operating at a disadvantage on the world market given the trade distortions in Madagascar. Inclusive of institutional costs, the ERP drops much lower to -21%.

Firm B: marine products

No Zone or Code, Malagasy-owned, 100% exports, resource-intensive

Firm B is wholly Malagasy-owned and classified under neither the Code nor the Zone. Founded in 1989 as a middleman for export of marine products, the company exports 100% of its "production", which actually consists of the collection, refrigeration, storage, and export of fresh crustaceans to Europe and the Indian Ocean. The firm is resource-intensive, and non-labor intensive, employing 21 people but grossing 1.2 billion FMG annually (about $670,000). Value-added is high.

Major export constraints for this firm include refrigerated storage capacity at the airport, which limits volume, and capital for fixed investment. The firm does not import any inputs; it states that it is unable to import plastic bags because of delays in obtaining financing and foreign exchange. The firm notes that local bags are 30% more expensive but of a similar quality to imported bags. Although production slowed in 1991 due to political events, by September 1992, collection and processing had recovered sufficiently to export 2 to 3 containers per month of fresh, live seafood. Other constraints include a lack of personnel trained in handling this specialized product, minor problems in the regularity of air shipments, limited capacity of sea freight to the Indian Ocean, and domestic transport problems in the rainy season. There are also bitter complaints about the monopoly imposed on air freight by Air Madagascar. Export requirements include a certificate of origin and health from the Direction Pêche et Aquaculture (no formal fee required but a customary tip of FMG 10,000 to 35,000) and a free certificate of origin from the Chamber of Commerce. Although the firm qualifies as neither a Code nor a Zone enterprise, it has periodically obtained exoneration from the TUT due to the high proportion of its production going to exports.

This firm is also efficient, with a domestic resource cost coefficient of 0.72, but, like Firm A, it could be operating far more efficiently if institutional constraints were removed, since the adjusted DRC is 0.67. The major source of costs in this case is revenue lost from overvaluation of the FMG and the firm's lack of access to foreign exchange. This cost alone is estimated by the firm at 240 million FMG annually, or 20% of FOB sales. The firm would also be taxed on its inputs, if they were imported, with the NRP for these inputs equaling 11%. The firm suffers from negative effective protection of -8%, and this coefficient shrinks to -23% after accounting for institutional costs, the most important of which result from the unfavorable rate of exchange it receives for its export earnings.

Firm C: plants and oils
No Zone or Code, Malagasy-owned, 100% exports, resource-intensive

Firm C exports medicinal plants and oils indigenous to Madagascar. It is wholly Malagasy-owned, qualifies under neither the Code nor the *Zone Franche* and exports 100% of its production to Europe. The firm is resource-intensive, non-intensive in its direct use of labor (employing five people) and small in comparison to other exporters. Total sales in 1992 were 33 million FMG. This firm provides an example of what many very small, indigenous exporters may experience in the Malagasy business environment.

Major export constraints for this small firm include irregularity of shipments (only one shipment in the first half of 1993), due reportedly to problems of authorization both by the government of Madagascar and by customs officials of importing countries. Like Firm A, Firm C estimates that the cost of these delays in terms of lost orders and low client confidence has reached 25% of total sales, or in this case over 8 million FMG. The authorization problems occur as a result of delays in export approvals from the

Direction des Eaux et Forêts, and as a result of substandard crating and processing by shippers, which delays approvals in destination countries. The firm does not import any inputs.

The firm potentially has a strong comparative advantage, with an unadjusted DRC of 0.28 and a DRC adjusted for institutional costs of only 0.05. The reason for the large discrepancy is the heavy burden placed on the firm by administrative procedures, especially the requirements imposed by the *Direction des Eaux et Forêts*. The firm claims that these requirements have been used in a discretionary way to give one of its competitors an advantage. The implicit export tax rate of 37.8% may therefore indicate the magnitude of problems faced by many small Malagasy firms trying to get into the export business. This is also shown in the adjusted effective rate of protection, which equals -39%.

Firm D: garments
Zone Franche, foreign-owned, 100% exports, labor-intensive

Firm D is a foreign-owned manufacturer of garments founded in 1992. It is non-intensive in resource use, importing all of its primary materials, but quite intensive in labor, employing more than 400 people in production and management. It qualifies as a *Zone Franche* enterprise, and therefore is able to import all of its materials tax-free as long as the agreement is presented with each import shipment and the goods comply with primary materials itemized in the original agreement. The firm's gross sales were approximately 2.2 billion FMG for the first six months of operations in 1992, and all of its production was exported, primarily to European markets.

Firm D notes three constraints on exports. One is adequately trained workers, and the firm has solved this problem by creating its own training school for production line labor. Another constraint is import delays. Although imports are tax-free, the firm spends an average of 15 days obtaining clearance and authorization for its imported primary materials, filing forms at the Ministry of Industry, the Ministry of Finance, and the Ministry of Trade. The third constraint is adequate and reliable export transport capacity in the form of available containers to carry finished goods by rail or road from the factory in the capital city to the port at Toamasina. Due to formal ties with foreign entities, the firm has no constraints on financing capital investment or working capital needs, and no problem accessing foreign exchange.

These institutional costs are minimal in the overall cost structure of the firm. The firm operates efficiently (DRC = 0.46), and accounting for institutional costs does not improve that efficiency dramatically. However, the delays associated with customs clearance and transport delays and capacity, plus the need to convert some of its foreign exchange earnings into local currency at an unfavorable rate in order to pay local bills, amount to an implicit export tax rate 5.4%, which is high considering all of the other advantages afforded this firm as a *Zone Franche* enterprise. The fact that the effective rate of protection is 0% before, and 6% after, adjustment suggests that most of the disincentives that the firm faces are due to institutional barriers rather than trade policy distortions.

Firm E: pickles
Code and Zone, Malagasy-owned, 100% exports, labor-intensive

Firm E qualifies both under the Code (1989) and under the *Zone Franche* (1992). Its business is in fairly simple processing, packaging, and export of agricultural produce to Europe. Although wholly Malagasy-owned, it is run by a foreigner who has made use of all of the benefits pursuant to both legal regimes. The business is labor-intensive, employing 65 full-time workers and providing income for another 800 rural farmers who provide the agricultural produce that is processed for export. Total sales were more than FMG 2 billion in 1991, but dropped to FMG 1.2 billion in 1992 due to the social and political disruption.

The firm reports no problems with imported inputs; they consist of a single item used for packaging that is not available locally. The firm has also experienced no problems with export procedures, and finds the sea freight capacity and procedures affordable and timely. The only problem the firm faces is that it is operating at full capacity and would like to expand production facilities but cannot due to the lack of medium and long-term credit. These costs are not included directly in the calculation of the coefficients or the implicit export tax rate. The only institutional costs borne by the firm stem from the labor required to clear customs. There is also the need to convert some foreign exchange into local currency at the bank rate These costs amount to 3.3% of total sales FOB. The costs are easily borne since the firm's DRC even after adjustment is a healthy 0.29.

G. Policy recommendations

The analysis thus far underscores the fundamental importance of the exchange rate for promoting exports and growth in the private sector. Thus the policy measures taken in May 1994 to allow the exchange rate to be determined by market forces, which resulted almost immediately in a large depreciation, were essential to encouraging nontraditional export growth. In addition, the narrowing of the margin between the interbank and parallel market rates of exchange reduced substantially the cost to exporters of having to convert most of their foreign exchange earnings through the banking system.

The analysis also suggests that several other short and long-term policy initiatives could contribute to export growth. Short-term measures include increased ability of exporters to retain foreign exchange, faster and simpler procedures for exports and importation of imported inputs, implementation of a scheme for duty-free admission of imported inputs under the *droit commun*, and opening of the Air Madagascar air freight monopoly to competition. Longer term measures include infrastructure development for improved intermodal transport and cargo transfer, continued liberalization of the financial sector, and judicial reform.

1. Short-term Measures

a. Implementation of Loi No. 91-014 12/08/1991

Even though the losses associated with exporters having to convert their foreign exchange earnings to FMG through the banking system have been substantially reduced with the interbank float, the potential still exists for those losses to increase should the central bank intervene either directly in the interbank market or by exerting pressure on the banks to restrict their allocation of foreign exchange to importers. This creates uncertainty among exporters, given the experience of the past, and inhibits investment in export activities. The only way to lessen this uncertainty is to allow exporters to hold their earnings as foreign exchange. Experience has shown that this does not result in a massive flight of capital. Rather, exporters are encouraged to repatriate their foreign exchange earnings in order to pay their recurrent cost obligations and finance new investment.

Certainly, a ministerial *décret* implementing once and for all the law that permits Malagasy businesses to hold foreign exchange accounts (*Loi No. 91-041 12/08/1991*) would encourage exports, reduce the gap between foreigners and Malagasy, and provide equal treatment for firms inside and outside the *Zone Franche*. It would also decrease the government's ability to maintain an overvalued FMG since importers would not be forced to go to the banks to obtain foreign currency. This would help to assure fewer and less severe price distortions biased against exports.

b. Faster and Simpler Procedures for Trade Clearance

Second only in importance to the exchange rate is the ability of traders to move goods in and out of the country with a minimum of delay and cost. The delays associated with customs clearance affect every exporter and importer regardless of their legal status and nationality, though Malagasy exporters appear to suffer longer delays than foreign exporters. The government could either increase the resources of the *Direction des Douanes*, to provide better implementation of existing regulations and procedures, or reduce the costs of those regulations and procedures by decreasing their number and complexity. Clearly, the latter option is more consistent with the overall goals of increasing efficiency.

A reduction in the number and complexity of export and import procedures would greatly relieve the demands placed on the limited customs service. Elimination of the *Domiciliation Déclaration Exportation et Engagement de Rapatriement de Devises*, which would no longer be necessary if exporters were free to retain 100% of their foreign exchang earnings, would help. So would the elimination of the need for approvals from technical ministries, except in the case of food products where health considerations are important and where relevant certifications are generally required by importing countries. Finally, although the *patente d'exportateur* is a convenient way for local governments to raise revenues, it constitutes an export tax when exports already suffer, as we have seen, from a number of other disincentives.

Establishment of a *guichet unique* is another option for reducing the time and complexity of export and import clearances without increasing the costs of the *Direction des Douanes*. A single office empowered by the relevant ministries to rule on issues of health, authenticity, and other standards could reduce costs for firms and the frequency of shipment delays. The *guichet* could consolidate its operations at key embarkment points, such as the port at Toamasina and the Ivato airport, with other agents available for on-site checks prior to packaging. The government already has some experience with a *guichet unique* created to facilitate approvals under the investment code. The *guichet* need not constitute a new layer of inter-ministerial bureaucracy. It could be established, instead, as part of a broad-based institutional effort to increase the efficiency and improve the standards of the *Direction des Douanes* within the finance ministry.

c. Duty-free Admission of Imported Inputs

Even in the absence of export taxes, the effective rate of protection on exports is negative if there are duties or other taxes on imported intermediate inputs. This contrasts with import-competing activities, where the effective rate of protection is positive because taxes on imported inputs are usually more than offset by the protective effects of taxes assessed on imports of the final product with which the local activity is competing. To overcome this export disincentive, exporting countries throughout the world have established mechanisms for allowing firms to use imported inputs in the production of exports without payment of duty or other taxes. Some of these mechanisms also exist in Madagascar, in principle if not in practice. As discussed earlier, these include the *zone franche*, the *régime suspensif des droits*, and exemption from the TUT if exports total more than 75% of total sales.

As we have seen, the *zone franche* scheme in Madagascar works fairly well, though firms within the Zone are not totally free of administrative delays and other procedural difficulties. The main problem with the scheme, however, is that it effectively discriminates in favor of larger firms, often owned or controlled by foreigners, that are highly oriented towards the export market. In contrast, smaller, Malagasy-owned firms that produce only partly for the overseas market find themselves faced with high taxes on imported inputs. This results in their having to depend on locally procured inputs, which may be more costly and frequently are of poorer quality. As a result, most of these firms tend to export resource-intensive products, which benefit from the scarcity value of Madagascar's natural resources and require few other inputs. Yet over the longer term, Madagascar's comparative advantage is likely to evolve towards the production and export of labor-intensive goods, such as garments, which have a relatively high content of imported inputs.

Although the *régime suspensif des droits* is occasionally used by some of the larger, more export oriented firms, it is not at present an effective way of admitting imported inputs duty-free. The approval process is far from transparent and is subject to abuse. Many firms do not even know about the procedure. Similar problems exist with the TUT exemption based on exports totaling 75% or more of total sales. In this case, there is also discrimination against firms that export less than 75% of their total sales volume.

The Malagasy government is currently reviewing its special incentive programs to see (1) how the disparities between these and the *droit commun* can be reduced and (2) how to reduce the abuses that occur in the implementation of these programs. The objective is to have a single set of incentives available to all firms, but with adequate controls to assure that these incentives are not abused. A major problem to date has been that control by customs is executed manually, which takes time and increases the likelihood of error, discretionary decisions, and abuse. Computerization is essential to effective operation of any incentive scheme. This would permit rapid and accurate tracking of a firm's export-import operations. Sets of input-output coefficients could be calculated and used to determine duties and other taxes owed or paid. Systems such as this have been used in East Asia and elsewhere for several years. It would be very useful to examine the experience with these systems in order to determine how well they work and what problems have been encountered. But it is also important to bear in mind that what has worked well in Asia might not work so well in Africa. Thus it is important to monitor the experience in Africa as governments try to come to grips with the problem of providing duty-free access more systematically and to a broader range of firms.

Consideration is also being given to going to a drawback system whereby credit would be given for duties paid on goods used in the production of exports, with this credit redeemable at the time that future taxes are due. Drawback systems have not functioned well in Africa, however, and the time that a firm's capital would be tied up could be critical.

d. Increased Competition among Freight Companies

While little can be done about the lack of competition for air and sea freight that results from the low volume of export activity, the same is not true of the monopoly conferred on Air Madagascar/Air France in the shipment of air freight. This legal monopoly on domestic and international operations should be eliminated and open competition should be encouraged, including the use of private air cargo planes as soon as the volume of activity makes this profitable. In addition, lifting the requirement that coastal trade be limited to vessels flying the Malagasy flag would also increase competition in this service.

2. Long-term Measures

a. Infrastructure Development

Although this report is not concerned primarily with infrastructure, it is evident that poor transportation and telecommunications not only increase costs but also have an important institutional consequence in that they limit a country's ability to respond to the exigencies of today's world markets, which require good timing and quality control. As a result, one cannot stress too much the importance of dealing with these problems as quickly as possible.

Streamlining the regulations and inefficiencies surrounding intermodal transfer of imports and exports (i.e., from railroad car or truck to cargo ship) would relieve a major constraint to efficient transportation. Some of the shipping capacity problems and customs clearance problems could be solved through creation of terminal and storage facilities in Antananarivo (plus a terminal at the airport) and in Toamasina. These facilities could provide headquarters for the *Direction des Douanes*, refrigeration facilities for lease by smaller entrepreneurs, and a collection point for containers, which are currently in constantly short supply at either end of the Antananarivo-Toamasina line. The terminals would also provide, of course, a locus for intermodal transfer of cargo and would optimize connections among rail, road, and air.

In addition, improvement in the road network would lower the cost of collection and transportation of all export products, but especially those that are produced or gathered over an extended area. Together with improvements in internal telecommunications, this would enable firms to respond much more quickly to overseas market opportunities. Telecommunication improvements may require such innovative approaches as expanded use of wireless systems, such as cellular telephones, that do not depend on heavy investment in central infrastructure.

b. Financial Sector Development

Madagascar is already well on its way to deepening the financial sector. The reforms that were launched with the 1988 Banking Law, initiating privatization of the banking sector, have profound implications for the export trade. Continuation liberalization and freeing up of the private sector will continue that process, but this must be accompanied by improved (not increased) regulation by public authorities to ensure transparency, improve contract enforcement, and increase the public's faith in the banking system. Especially important is the movement away from credit controls as a means of rationing foreign exchange, since this creates enormous uncertainty and discriminates against the smaller Malagasy exporter.

Notwithstanding, Madagascar's efforts to develop a market for term finance, the latter is still embryonic. As part of the development process, such market will develop spontaneously as financial systems become stronger and deeper. It is unclear how much this process can be accelerated without substantial subsidization, which most African countries cannot afford. Furthermore, subsidized credit schemes inevitably involve discretionary decisions regarding who has access to loans, and this runs counter to the general tenure of financial reforms, which has been to make lending more transparent and automatic as long as borrowers are willing to pay market rates of interest. Nevertheless, there may be ways in which term financing can be facilitated through the exploitation of economies of scale and diversification involved in such activities as leasing, insurance, and loan guarantee. These financial innovations should be strongly supported.

In the final analysis, however, the most effective way for governments to encourage the development of a market for term finance is through the maintenance of macroeconomic stability. Low rates of inflation, positive real rates of interest, and a stable exchange rate reduce the risks associated with financial intermediation and help to assure the financial viability of borrowers, making term finance more attractive to lending institutions.

With respect to working capital needs, insurance and loan guarantees may also play a useful role in helping small firms to gain access to short-term credit for working capital. Equally important, these firms need assistance in establishing banking relations, filling out loan applications, setting up accounting systems, and learning about other commercial and financial practices that are required if they are going to enlarge their scale of export operations. Frequently, this type of assistance can be incorporated into projects for the promotion of nontraditional exports, such as the Trade and Investment Program project in Ghana.

c. Judicial Reform

Perhaps the most sweeping reform that is necessary to reduce institutional constraints to nontraditional export growth in Madagascar is the development of the rule of law. While resorting to international arbitration represents a reasonable short-term solution, it is not ideal over the longer term because of its costs and unfamiliarity to many Malagasy entrepreneurs. Comprehensive legislative reform is needed with respect to business registration, the commercial code (which dates in certain places to colonial times), the power of judges to make law, the code of civil procedure, arbitration, export regulations (where inconsistency remains as a result of the adoption of conflicting laws), regulation of foreign participation, and banking law. Of particular interest for this study were:
land and labor regulations and contract enforcement.

Complicated or Restrictive Regulations Regarding Land and Labor

Few firms mentioned labor and land regulations as important problems inhibiting the expansion of nontraditional exports. One reason for this, in the case of labor, is either that the firms are exempt from these requirements because of their being approved under one of the special incentive programs or that they simply hire labor temporarily so as to avoid the requirements. In neither instance are the requirements being complied with, though their existence may make firms reluctant to hire new workers. It would be preferable, therefore, to liberalize substantially the hiring and firing of labor so as to enable firms to rid themselves of unproductive workers and to adapt flexibly to changing economic circumstances.

Although most firms in the surveys did not cite problems with land registration as being very important, there are enough instances in which they have been important that there is a need to take action. In Ghana, much could be accomplished by simply publicizing very clearly the various steps that must be taken to register land and by noting the severe complications that can occur if each of these steps is not taken in the order required. In Madagascar, the situation is more complicated because of the absence of up-to-date and clearly written legislation regarding land registration. The passing of this legislation should have high priority.

Contract Enforcement with Overseas Importers

Problems of contract enforcement are common in international trade and institutional means exist to overcome them. One of the most common is to engage the services of a reputable surveyor to assess damages. This is often done by the importer, with the surveyor's report made available to the exporter. Exporters should insist on such a procedure whenever damage claims are made.

d. Qualified Labor and Middle-level Managers

Means should be sought for governments to support the private sector in its training of labor and middle-level managers for the nontraditional export sector. This support could take the form of tax credits to individual firms where the training would carry benefits that the firm is not able to capture fully. Alternatively, the public sector could join with professional associations in developing training programs at the industry level.

e. Implementation of Special Incentive Schemes

Like in many developing countries, the trend in Madagascar is towards making special incentive schemes such as the investment code or *Zone Franche* more promotional and less regulatory, simplifying and accelerating the approval process, and providing benefits after, rather than before, requirements have been met. The next step would be to incorporate these incentives directly into tax and other codes so that they would be available to all firms that met the requirements rather than just those that are approved. This would allow the agencies responsible for administering these schemes to become truly promotional. By definition, this approach would also eliminate delays and costs incurred in obtaining approval and would be based on *ex post*, rather than *ex ante*, justification. Most important, this approach would eliminate most of the discretionary authority involved in the approval process and would reduce the bias that exists against smaller, local firms.

IV. RESEARCH CONCLUSIONS

1. Research conclusions

Several conclusions emerge from these cases studies. The first conclusion is that it is possible to measure quantitatively some, if not all, of the costs associated with institutional barriers to the expansion of nontraditional exports and that these costs are considerable even in countries that have undertaken fundamental economic reform. The costs that were successfully measured in this case are those related to (1) controls on exporters' use of foreign exchange earnings, (2) lack of workable procedures for duty-free admission of imported inputs, and (3) unnecessary administrative delays and procedures involved in the clearance of exports and imported inputs.

These costs are treated in the following manner. First, to the extent that the barriers result in an underestimate of the true value of exports, as when firms are required to convert foreign exchange earnings into local currency at an unfavorable rate of exchange, the domestic resource cost (DRC) as conventionally measured is too high and comparative advantage is underestimated relative to its true value. The difference between the value of exports measured at the rate of exchange actually received and that measured at the rate that would exist if there were no exchange controls is equivalent to a tax on exports.[67]

Second, the costs resulting from lack of workable procedures for duty-free admission of imported inputs are considered to be the import tariffs and other taxes actually assessed on these inputs. These are treated in the conventional manner and are not labeled as institutional costs, though in fact inputs would probably be admitted free of duty if it were possible to devise and implement workable procedures for their duty-free importation.

Third, the costs of labor and capital required because of unnecessary delays and procedures involved in the clearance of exports are the equivalent of a tax on exports. These are subtracted from the numerator of the DRC and are added to any direct export taxes that may be imposed plus the export tax equivalent resulting from exchange controls. The costs of labor and capital needed because of unnecessary delays and procedures involved in the clearance of imported inputs are the equivalent of an import tariff on these inputs. These are subtracted from the numerator of the DRC and are added to any other taxes assessed on imports.

The net effect of these costs is very substantial for many firms. An unweighted average of effective rates of protection resulting from these costs equals 18.6 in Madagascar. This is a very high rate of negative protection for firms trying to compete in the world's export markets, even before taking into account the additional bias against exports resulting from overvaluation of the exchange rate and positive protection for the import-competing sector. Thus application of the methodology to even this limited range of institutional barriers reveals their importance.

2. Limitation of the methodology

[67] Note that applying this correction is not equivalent to valuing exports at the free trade equilibrium, or shadow, rate of exchange, which also takes into account the effects of tariffs, taxes, and quantitative restrictions on imports that cause the local currency to be overvalued. Both corrections are necessary and in fact were made to obtain the DRCs in Chapters II and III.

There are a number of other costs associated with institutional constraints that have not been measured. These include lack of access to capital, problems in the implementation of special incentive schemes, lack of competition for air and sea freight, effects on quality and timeliness resulting from inadequate transportation and telecommunications, excessive regulations regarding land and labor, lack of qualified labor and managers, and problems in contract enforcement with overseas importers. There is also the bigger issue of the weak legal and judicial systems that characterize the entire African continent.

The reasons for the difficulty in measuring the costs associated with these constraints are several. In some instances, such as lack of access to capital, it is not clear how much the problem is due to fundamental factors related to development and how much it is due to impediments amenable to policy change. In other instances, such as the problems linked to special incentive schemes and to the regulation of land and labor, not only are the costs difficult to measure but also it is hard to determine to what extent these costs impede the expansion of nontraditional exports. Finally, as with the problems of contract enforcement reported by exporters, it is not always clear to what extent real costs are involved or there is simply the need for better information.

We have not yet tried to measure quantitatively the costs associated with removing institutional barriers to nontraditional exports. We have made qualitative assessments, however, in deciding whether a barrier should be treated as a real cost or as an institutional cost amenable to policy change. In addition, once a cost has been identified as institutional, recommendations have been made regarding its removal, though the costs of this removal, which may be largely political in nature, have not been assessed.

Despite its limitations, the methodology described in this report has proven itself to be highly useful in identifying and measuring the costs of a number of important barriers to the expansion of nontraditional exports. It has also revealed how significant the bias against nontraditional exports still is despite all of the progress that has been made in countries such as Ghana and Madagascar.

The research methodology is sufficiently developed that it can be extended fairly easily to other African or, for that matter, non-African countries. This should normally require about one month initially to review documentation, interview knowledgeable public officials and business people, and set up the survey of exporting firms. The survey can be conducted and analyzed and the draft report can be prepared during the ensuing three months, after which a second visit to the country should be scheduled to discuss and verify the results and to gather any further data. The final, revised report should be available within six months of the project's initiation. This report would identify the major institutional constraints on the expansion of nontraditional exports and would estimate the quantitative importance of the costs associated with those constraints. It would also make specific recommendations regarding policy changes that can be implemented in the short to medium term, as well as discuss longer term impediments to trade that need to be resolved.